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IMPLICATIONS OF H.R. 3838, THE TAX REFORM ACT

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

ON

THE IMPACT OF THE HOUSE PASSED TAX BILL (H.R. 3838) ON INSTITUTIONS WITHIN THE JURISDICTION OF THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

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CONTENTS

TUESDAY, FEBRUARY 4, 1986

Page

Opening statement of Chairman Garn 1

Opening statements of:

- Senator D'Amato 2
- Senator Mattingly 3
- Senator Dixon 3
- Senator Heinz 109

WITNESSES

James H. Mack, public affairs director, National Machine Tool Builder's Association, McLean, VA 4

- Decline in machine tool industry 4
- Bill would double taxes over 5-year period 6
- Prepared statement 7
  - I. Introduction and competitive overview 7
  - II. Capital formation is essential to international competitiveness 9
  - III. H.R. 3838 is anticompetitive and antimanufacturing 10
  - IV. Conclusion 13
  - Exhibit I—The stimulating effect of investment tax credit 13
  - Exhibit II—The investment tax credit and productivity 14
  - Exhibit III—Impact of various proposals on depreciation of $4 billion annual machine tool sales 14
- Response to written questions of:
  - Senator D'Amato 127
  - Senator Proxmire 128
  - Senator Riegle 129
  - Senator Sasser 131

Paul R. Huard, vice president, taxation and fiscal policy, National Association of Manufacturers, Washington, DC 15

- Bill increases corporate taxes by $140 billion over a 5-year period 15
- Prepared statement 17
  - I. Introduction 17
  - II. The taxation of investment and consumption 18
  - III. The effects on the cost of capital 20
  - IV. Implications for the aggregate economy 23
  - V. Comparison of depreciation systems 26
  - VI. The treatment of domestic and foreign source income 27
  - VII. Conclusions 28
  - Appendix I—Various tables showing cost to U.S. corporate nonresidential fixed capital by asset in moving from present law to H.R. 3838 29
  - Appendix II—Tables showing the implications for the aggregate economy 37
  - Appendix III—Tables showing comparison of depreciation systems 42
- "Tax Reform and the U.S. Business Sector," article by Allen Sinai 76
- Response to written questions of:
  - Senator D'Amato 134
  - Senator Proxmire 136
  - Senator Riegle 138
  - Senator Sasser 140

Page

- Robert D. Hostetler, president and chief executive officer, CTS Corp., Elkhart, IN, representing the Electronic Industries Association 50
  - Trade deficit of $11 to $12 billion last year 50
  - Favor broad-based consumption tax 51
  - CTS Corp. situation 52
  - Prepared statement 53
    - R&D tax credit 54
    - Section 861 55
    - Investment tax credit 55
    - Foreign tax credit 56
    - Depreciation rates and schedules 56
    - Elimination of foreign source income for exports and reduction in FSC benefits 56
    - Completed contract method of accounting 56
    - Broad based consumption taxes 57
    - Conclusion 57
  - Response to written questions of:
    - Senator D'Amato 142
    - Senator Proxmire 144
    - Senator Riegle 146
    - Senator Sasser 147
- George J. Clark, executive vice president, Citibank, N.A., New York, NY, representing the National Foreign Trade Council 58
  - Effects of H.R. 3838 on foreign lending 58
  - Global debtor problem 59
  - Prepared statement 61
  - Response to written questions of:
    - Senator D'Amato 150
    - Senator Proxmire 152
    - Senator Riegle 154
- Panel discussion:
  - H.R. 3838 will not achieve reform 64
  - Need for a new revenue source 66
  - Minimum tax on corporations 67
  - Banks pay between 2 or 3 percent net in taxes 69
  - 9 million new jobs in America 71
  - Fair share from new technology 72
  - Looking at the 1981 bill 75
  - Japan is improving its depreciation program 106
  - Tax fairness 111
  - Possible global debt crisis 113
- Lowell R. Beck, president, National Association of Independent Insurers, Des Plaines, IL 114
  - Insurance industry shoulders its share of the tax burden 114
  - Prepared statement 116
  - Response to written questions of:
    - Senator D'Amato 155
    - Senator Sasser 157
- Thomas P. Maletta, vice president—taxes, Household International, Inc., Prospect Heights, IL., representing the American Financial Services Association 118
  - Reserve method of accounting for bad debt deductions 118
  - Deductibility of consumer interest payments 119
  - Prepared statement 122
    - Bad debt reserve method 122
    - Deductibility of consumer interest payments 124
    - Reorganizations of financially troubled thrift institutions 124
    - Foreign tax credit 124
  - Response to written question of:
    - Senator D'Amato 163

WEDNESDAY, FEBRUARY 5, 1986

- Opening statement of Chairman Garn 165
- Letter from Chairman Seidman of the FDIC 305

Page

Opening statements of:

Senator D'Amato 165
Senator Dixon 167
Senator Mattingly 168
Senator Gorton 168
Senator Heinz 265

WITNESSES

Donald T. Senterfitt, vice chairman, Sun Trust Banks, Inc., Atlanta, GA; president, American Bankers Association, accompanied by Richard C. Amacher, chairman, taxation committee, American Bankers Association 169
  Tax on loan loss reserves 169
  Disallowance of interest deduction on tax-exempt obligations 170
  Prepared statement 172
    Appendix: Memorandum on H.R. 3838 184
  Response to written questions of:
    Senator Heinz 311
    Senator D'Amato 314
B.F. (Chip) Backlund, president, Bartonsville Bank, Peoria, IL; president, Independent Bankers Association of America 200
  Prepared statement 201
    Net operating loss [NOL] carryover 202
    Loan loss reserves 204
    Cash accrual accounting 205
    Denial of deduction for carrying tax-exempt bonds 206
    Individual retirement accounts 206
    Credit union taxation 207
    Exhibit I. Bank A—Actual tax refunds from the 10-year net operating loss carryback 208
    Exhibit II. Bank A—Statement of condition—1982 208
    Exhibit III. Bank B—Actual tax refunds from the 10-year net operating loss carryback 209
    Exhibit IV. Bank B—Statement of condition—1980 209
    Exhibit V. Bank C—Table showing a bank in Peoria, IL, showing loan-loss reserves 210
  Response to written questions of:
    Senator Heinz 318
    Senator D'Amato 324
J. Thomas Macy, audit partner, Price Waterhouse, New York, NY; representing the American Institute of Certified Public Accountants 211
  Prepared statement 211
    Financial statements 212
    Income measurement 213
    Historical income tax treatment of bank bad debt reserves 215
    Not a tax loophole 215
    Bank safety and soundness 216
    Recommendation 217
  Response to written questions of:
    Senator Heinz 328
    Senator D'Amato 328
Walter V. Shipley, chairman of the board and CEO, Chemical New York Corp., New York, NY; representing the New York Clearing House Association, accompanied by Robert J. Quinlan, senior vice president and director of taxes for Chemical Bank, and chairman of the taxation committee, the New York Clearing House Association 218
  Adverse effects of the two provisions 219
  Hindrance to financing of U.S. exports 220
  Interest foregone on bank reserves 220
  Interest foregone on tax-exempt obligations 221
  Prepared statement 222
    I. Denial to large banks of tax deductions for reasonable bad debt reserves 223
    II. Adverse foreign provisions 227
    III. Commercial banks pay a fair share of taxes 234
  Response to written questions of:
    Senator Heinz 331
    Senator D'Amato 334

Page

Panel discussion:

- Fed should pay interest on reserves 236
- Bill full of throwaways 237
- Cost up 2 percent for municipal bonds 239
- President will veto present bill 240

Charles H. Miller III, head of trade finance, Philadelphia National Bank, Philadelphia, PA; representing the Bankers' Association for Foreign Trade 242
- BAFT opposes section 602 of H.R. 3838 242
- Meaning of trade finance 243
- Bill impacts banks ability to finance exports 244
- Prepared statement 246
  - The scope and importance of trade financing 247
  - Proposed changes to the foreign tax credit 248
  - Adverse impacts of changes in the foreign tax credit on export financing 249
  - Adverse impacts on U.S. exports 250
  - Conclusion 253
  - Exhibit A. International assets of banks by country of parent bank 253
  - Exhibit B. Foreign countries imposing withholding taxes 254
- Response to written questions of:
  - Senator Heinz 339
  - Senator D'Amato 340
  - Senator Sasser 341

Alberto Parracchini, president and chairman, Banco de Ponce; representing the Puerto Rico Bankers Association and Puerto Rico League of Savings Institutions 255
- Prepared statement 255
  - Section 936 and Puerto Rico's financial system 255
  - Amendments to section 936 proposed by H.R. 3838 256
  - Amendments to section 861 proposed by H.R. 3838 257
  - Conclusion and recommendations 258

Robert Cassidy, executive vice president of Bayerische Vereinsbank; representing the Institute of Foreign Bankers, chairman of tax committee 259
- Prepared statement 259
  - 1. Background 260
  - 2. The branch level tax is not needed for foreign banks because the choice of form of organization of a foreign bank's U.S. operations is not tax motivated 261
  - 3. A second level branch tax would discriminate against foreign banks 262
  - 4. The House bill would create an undesirable conflict with existing U.S. treaty obligations 263

Panel discussion:

- No economic benefit associated with withholding tax 267

Joseph C. Morris, president, Columbia Savings Association, Emporia, KS; vice chairman, U.S. League of Savings Institutions 268
- Effects of H.R. 3838 on housing financing 268
- No relief for accumulated net operating losses 269
- Prepared statement 271
  - Thrifts as corporate taxpayers—a historical perspective 272
  - Thrift tax burden increases 275
  - Reserve accounting and thrift portfolio restrictions 276
  - Proposed recapture of bad debt deductions 277
  - Preserving some reserve for thrift institutions 279
  - Preserving existing net operating losses 281
  - Cash to accrual accounting 284
  - Delay repeal of reorganization rules for financially troubled thrifts 287
  - Section 321 of the House bill, corporate mergers and reorganizations 288
  - Incentives to encourage additional savings should be expanded 291
  - Support for lower corporate tax rate 292
  - H.R. 3838 effective dates need to delayed 293
  - Federal deductibility of State and local taxation 295
- Response to written questions of Senator D'Amato 342

Kenneth F.X. Albers, chairman, Provident Savings Bank, Jersey City, NJ; chairman, National Council of Savings Institutions 297
- Prepared statement 297
  - General comments on H.R. 3838 297
  - Net operating loss [NOL] carryover 298

Page

Kenneth F.X. Albers, chairman, Provident Savings Bank, Jersey City, NJ; chairman, National Council of Savings Institutions—Continued
  Prepared statement—Continued
    Bad debt reserve deduction ... 299
    Repeal of reorganization rules for financially troubled thrifts ... 300
    Net operating losses in acquisitions and mergers ... 301
    Cash method of accounting for tax purposes ... 302
    Retirement accounts (IRA's and 401(k)'s) ... 302
    Conclusion ... 303
  Response to written questions of Senator D'Amato ... 344
Panel discussion:
  H.R. 3838 would inhibit conversions ... 308
  Lack of transitional rules in House bill ... 309

THURSDAY, FEBRUARY 6, 1986

Opening statement of Chairman Garn ... 347
Opening statements of:
  Senator Dixon ... 364
  Senator D'Amato ... 366
  Senator Cranston ... 381
    Prepared statement ... 382
  Senator Mattingly ... 402
    Prepared statement ... 403
    Letter to Senator Packwood ... 405
  Senator Heinz ... 438
  Senator Riegle ... 524

WITNESSES

Richard Guthman, council member, Atlanta, GA; on behalf of the National League of Cities ... 347
  Uncertainty of funding levels creates problems ... 348
  Proposal to repeal deductibility of State taxes ... 349
  Taxing municipal bonds ... 351
  Reduction in low-income housing ... 353
  Prepared statement ... 355
  Problems stemming from retroactive date ... 364
  Response to written questions of Senator Heinz ... 564
Edward Alter, treasurer, State of Utah ... 370
  No imput by local or State sector ... 371
  Death knell of public-private joint ventures ... 372
  Bill adds to administrative costs ... 373
  Prepared statement ... 375
  Response to written questions of Senator Heinz ... 568
David Herlinger, executive director, Colorado Housing Finance Authority; on behalf of the CIL Council, Council of State Housing Agencies ... 377
  Focus on housing ... 377
  Eliminate sunset on mortgage revenue bonds on home ownership ... 379
  Concern for consumers ... 381
  Response to written questions of:
    Senator Heinz ... 570
    Senator D'Amato ... 574
Leo Henikoff, Jr., president, Rush Presbyterian St. Luke's Medical Center, and president, Rush University, Chicago, IL ... 384
  Prepared statement ... 385
  Response to written questions of Senator Heinz ... 577
William A. Holby, partner, King & Spaulding, Atlanta, GA; on behalf of the National Association of Bond Lawyers ... 388
  Disallowance of interest expense on tax-exempt bonds ... 388
  Prepared statement ... 391
    Disallowance of interest deductions ... 393
    Property and casualty insurance companies ... 395
    Alternative minimum tax ... 396
    Conclusion ... 396
  Response to written questions of:
    Senator Heinz ... 579

Page
William A. Holby, partner, King & Spaulding, Atlanta, GA; on behalf of the National Association of Bond Lawyers—Continued
  Response to written questions of—Continued
    Senator D'Amato ... 581
    Senator Mattingly ... 582
Claude Pepper, U.S. Representative in Congress from the House of Representatives ... 397
Xavier Suarez, mayor, city of Miami, FL ... 398
  Housing needs ... 398
  Prepared statement ... 400
  Response to written questions of Senator Heinz ... 583
Richard F. Kezer, senior vice president, Citibank, New York; on behalf of the Public Securities Association and Dealer Bank Association ... 407
  Act will increase State and local taxes ... 407
  Effects on privatization ventures ... 408
  Prepared statement ... 410
    Introduction ... 410
    The financial challenges currently facing State and local governments ... 411
    The legislative setting ... 413
    Effective date ... 414
    The 5- and 10-percent rule ... 416
    Nonessential function bonds ... 417
    State volume caps ... 419
    Minimum tax on individuals and corporations ... 420
    Commercial bank impact ... 421
    Property and casualty insurance company impact ... 421
    Arbitrage restrictions ... 422
    Advance refunding ... 422
    Conclusion ... 423
  Response to written questions of:
    Senator Heinz ... 585
    Senator D'Amato ... 588
Bernard Tetreault, immediate past president, Association of Local Housing Finance Agencies ... 425
  Bill would cripple remaining tool ... 425
  Prepared statement ... 427
  Proposed legislation ... 430
  Response to written questions of:
    Senator Heinz ... 597
    Senator D'Amato ... 599
Panel discussion:
  Defining public purpose is difficult ... 437
  Definition narrowed on public purpose bonds ... 440
  Revision imperative on January 1, 1986 date ... 441
John Koelemij, president, Orange State Construction Co., Tallahassee, FL; on behalf of National Association of Home Builders ... 442
  Two-thirds of all households own their homes ... 443
  Prepared statement ... 445
    I. Overview ... 445
    II. Single-family housing ... 447
    III. Multifamily housing ... 452
    IV. Other provisions ... 460
    V. Economic impact ... 462
    VI. Conclusion ... 464
    Attachment A. Decisions affecting housing ... 465
    Attachment B. Tax reform proposals affecting housing ... 467
  Response to written questions of Senator D'Amato ... 601
G.V. Mike Brenneman, Jr., chairman, legislative subcommittee on taxation, National Association of Realtors ... 476
  Deductions for property taxes and interest preserved ... 476
  Raise maximum capital gains tax rate to 22 percent ... 477
  Prepared statement ... 479
    I. Introduction ... 479
    II. Homeownership provisions of H.R. 3838 ... 480
    III. Rental housing provisions of H.R. 3838 ... 481
    IV. Effective dates and transition rules ... 483
    V. Macroeconomic impacts—tables ... 485

Page

G.V. Mike Brenneman, Jr., chairman, legislative subcommittee on taxation, National Association of Realtors—Continued
- Response to written questions of Senator D'Amato ... 609

Ronald F. Poe, president, Dorman & Wilson, Inc., White Plains, NY, on behalf of the Mortgage Bankers Association ... 488
- MBA supports reduction of budget deficits ... 488
- Interest on low-income housing ... 489
- Prepared statement ... 491
  - Homeownership as a national priority ... 493
  - H.R. 3838, the Tax Reform Act of 1985 ... 493
  - Conclusion ... 499
  - Exhibit 1. Comparison of first year after-tax homeownership costs under current law, President's tax proposal, and H.R. 3838 ... 500
  - Exhibit 2. Impact of the Ways and Means Committee proposal on first year after-tax cost of homeownership, by family income, for a married couple filing jointly ... 501
  - Exhibit 3. Impact of President's tax reform proposal, on first year after-tax cost of homeownership, by family income, for a married couple filing jointly ... 501
- Response to written question of:
  - Senator D'Amato ... 613
  - Senator Riegle ... 617

Robert F. Sherman, president, S&S Properties, Inc., Dallas, TX, and president, National Apartment Association ... 502
- Bill would increase rents ... 502
- Four provisions of concern with H.R. 3838 ... 503
- Prepared statement ... 505
  - Depreciation ... 509
  - Interest expense ... 509
  - Alternate minimum tax ... 509
  - Tax-exempt housing bonds ... 510
  - Rapid amortization of costs ... 511
  - Effective dates ... 511
  - Table I. Household income and median housing expenses as a percent of household income—1983 ... 512
  - Table II. Cumulative effects of President's proposal ... 513
- Response to written questions of:
  - Senator D'Amato ... 619
  - Senator Riegle ... 621

Stephen D. Driesler, executive vice president, National Multi-Housing Council ... 514
- Bond market is completely dead ... 514
- Rent increase ... 515
- Inequities in the allocation of money ... 517
- Prepared statement ... 519
- Response to written questions of:
  - Senator D'Amato ... 623
  - Senator Riegle ... 627

J. Roderick Heller III, president, National Corporation of Housing Partnerships ... 524
- Preservation of existing stock housing ... 525
- Prepared statement ... 527
  - I. NCHP ... 527
  - II. Construction and preservation of housing ... 527
  - III. Attracting capital to rental housing ... 528
  - IV. H.R. 3838's impact on rental housing ... 529
  - V. Proposals ... 529
  - VI. Conclusion ... 530

Barry Zigas, president, National Low Income Housing Coalition ... 532
- More direct spending ... 532
- Prepared statement ... 534
  - The low-income housing crisis ... 534
  - The Federal response ... 535
  - Tax reform in H.R. 3838 ... 535
  - Constructive proposals ... 536
  - Summary ... 538
  - Attachment 1—Rental housing crisis index ... 538

Page

- Barry Zigas, president, National Low Income Housing Coalition—Continued
  - Prepared statement—Continued
    - Attachment 2—Summary of recommendations for new provisions for low-income housing in H.R. 3838 542
  - Response to written questions of:
    - Senator Heinz 631
    - Senator Riegle 633
- Robert D. Maffin, executive director, National Association of Housing and Redevelopment Officials 545
  - Multifamily housing bonds 545
  - Prepared statement 547
    - Multifamily housing development bonds 548
    - Mortgage subsidy bonds 548
    - Tax increment financing 549
    - Investment incentives 549
    - Attachment—NAHRO position on H.R. 3838 550
  - Response to written questions of:
    - Senator Heinz 634
    - Senator Riegle 636
- Panel discussion:
  - No. 1 issue is to control inflation 561

Additional Material Supplied for the Record

- American Association of Retired Persons 638
- American Federation of Labor and Congress of Industrial Organizations 644
- American Public Transit Association 647
- American Retail Federation 651
- Association of Reserve City Bankers 662
- The Bankers Committee 664
- Cain Brothers, Shattuck & Co 694
- The Chase Manhattan Bank, N.A 696
- The Coalition of Service Industries 718
- Fannie Mae 724
- Federal Deposit Insurance Corp 727
- Federal Home Loan Bank Board 730
- Federal Savings and Loan Insurance Corp 755
- First Boston Corp 757
- First Interstate Bank of Nevada, N.A 770
- Johnson, Bruce, law office 789
- Manufactured Housing Institute 820
- Mintz, Levin, Cohn, Ferris, Glovsky & Popeo, P.C 826
- Municipal Finance Industry Association 835
- National Association of Federal Credit Unions 860
- National Association of Home Builders 865
- National Conference of State Legislatures 872
- National Leased Housing Association, the Coalition for Low and Moderate Income Housing, and the Council for Rural Housing and Development 880
- National Low Income Housing Coalition 889
- The New York Hospital 893
- Professional Insurance Agents 896
- The Public Securities Association 919
- Republic National Bank of New York 950
- Scientific Apparatus Makers Association [SAMA] 960

THE IMPLICATIONS OF H.R. 3838, THE TAX REFORM ACT

TUESDAY, FEBRUARY 4, 1986

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 10:15 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, Armstrong, D'Amato, Gorton, Mattingly, Hecht, Proxmire, Cranston, Riegle, Dixon, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The Chairman. The Banking Committee will come to order. Today, the committee begins the first of 3 days of hearings on the House passed tax bill, H.R. 3838. This bill addresses virtually every aspect of the current Tax Code and some of its proposed changes would have a significant impact on areas that have been in this committee's jurisdiction.

For that reason, the committee earlier asked more than 60 trade associations and other organizations for comments regarding the effect of the tax bill on their members.

On the basis of these comments, these 3 days of hearings will hear from the financial services industry, the housing industry, State and local governments, and manufacturers.

The purpose of these hearings is to inform committee members and the full Senate as to the impact of tax reform legislation on competitiveness, as well as the safety and soundness of industries which are within this committee's jurisdiction.

Today's hearing focuses on the bill's impact on the manufacturing, insurance, and nonbank financial services industries. The committee appreciates the willingness of each of today's witnesses to testify.

We have also requested statements for the record from those organizations which are unable to testify today. When these hearings are complete, we will report our findings to the Finance Committee.

The Banking Committee has had indications of approval for this undertaking from the Finance Committee, given this committee's ability to pursue the details of the impact on areas within the Banking Committee's jurisdiction.

I stress that we have no jurisdiction over tax changes; that is totally in the jurisdiction of the Finance Committee. So our only purpose is to make recommendations to them and develop a much more complete hearing record on how the Tax Code affects those areas we have jurisdiction over.

But, again, not tax jurisdiction.

Gentlemen, we do appreciate your being here today. I am going to have to run out. I know I have a meeting down at the White House that was called at the last minute. And I apologize for having to leave, but Senator Gorton will take over. And I hope to get back before the hearing is over this morning. If I don't, I certainly will review your testimony.

Senator Gorton.

Senator GORTON [presiding]. Thank you.

Senator D'Amato, do you have an opening statement?

STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Thank you, Mr. Chairman. I commend you for planning these hearings, perhaps the most important hearings of this session, to address the consequences of H.R. 3838, the Tax Reform Act of 1985 on those institutions within the committee's jurisdiction. My position on the tax bill in its present form is no secret. I think the bill is totally unacceptable. It represents a patchwork quilt of compromises that do nothing to promote the goals of true tax reform and simplification. The bill totally ignores the economic realities that promote the growth of capital formation. The promotion of capital formation fuels our economy and any impediments to this process will slow economic growth and result in recession rather than expansion. Any legislation, such as this, that potentially leads to recession should be rejected by this body. We should not be stampeded into passage of a bill under the guise of tax reform that will prove so disruptive to our economy.

The House tax bill should not be called reform. It is tax complication and will do grave harm to the economy. The explanation of the bill is 1,076 pages long. Anything that lengthy cannot be simple.

The Congress did a great job in 1981 by encouraging capital formation principally through accelerated depreciation. Congress passed the Economic Recovery Tax Act with the encouragement of Treasury. Now Treasury tells us that accelerated depreciation is unnecessary. They say: "Turn the clock back". Take depreciation for real property from 19 years to 30 years and index those assets. Indexing will not make up for the added 11 years and will be tremendously complicated.

Many in the House want to restrict imports because of the burgeoning trade deficit. I agree that the trade deficit is a problem and that our trading partners are treating us unfairly. However, it is ludicrous for House Members to complain about the trade deficit and then pass a bill that will worsen our competitive position abroad. Loss of accelerated depreciation will reduce new investment and, thus, the competitiveness of our basic industries.

I fear, that despite our best efforts, the tax bill may not be greatly improved by the Senate. To remedy the mistakes made in the House bill, the Finance Committee appears to be contemplating more mistakes. For example, the imposition of an oil import fee, will be inflationary and worsen our competitive position abroad. Furthermore, an oil import fee will be a windfall for energy rich

States and hurt energy dependent States like New York. Tax reform should not pit one region against another region.

The second big mistake the Finance Committee is considering is limiting the State and local tax reduction. Any limitation of the State and local tax reduction would impose double taxation, which is antithetical to the notion of tax reform.

I hope that during our examination of H.R. 3838, we can reveal some of the major flaws in this legislation. Our efforts should not be undertaken with a desire to criticize our colleagues in the House, but to ensure that we accomplish the goals of tax reform—simplicity and fairness.

Senator **Gorton**. Senator Mattingly.

Senator **Mattingly**. The same thing, Mr. Chairman. I would like to have my statement included in the record.

[Senator Mattingly's prepared statement follows:]

OPENING STATEMENT OF SENATOR MATTINGLY

Mr. Chairman, I commend you for holding these oversight hearings. I, too, am concerned with the effect of the House-passed tax bill on those industries which come under the jurisdiction of the Senate Banking Committee. While we all generally support simplifying the Tax Code, lowering individual tax rates, and making sure every individual and business pays his or her fair share of taxes, such changes must be made in a manner that does not decimate certain sectors of our economy. I look forward to the testimony.

Senator **Gorton**. Senator Dixon.

STATEMENT OF SENATOR ALAN DIXON

Senator **Dixon**. Mr. Chairman, I am pleased to be here this morning as the committee begins the first of 3 days of hearings on the implications of pending tax reform proposals on areas of the committee's jurisdiction. I think it is altogether appropriate for the Banking Committee to hold these hearings; either the President's tax reform proposal or H.R. 3838, the House-passed bill, would have a profound impact on the American economy if enacted.

I come to these hearings as a supporter of the concept of a simpler and more fair Tax Code. There is no doubt that an ever-increasing percentage of American taxpayers believe our tax laws are inequitable, and that it is all too easy for those so inclined to avoid paying taxes on some or all of their income. Having said that, however, I must also say that I am at least somewhat skeptical regarding the effects that the President's proposal or the House proposal would have on our savings rate and on economic growth generally. I am concerned that tax reform as currently outlined may well increase the cost of capital and reduce our export competitiveness. There seems to be considerable evidence that tax reform may not increase savings rates and that it will result in lower economic growth for some time.

We have before the committee today representatives of manufacturing, financial, and insurance industries. I look forward to hearing their comments on the effects of current tax reform proposals on issues like capital formation, research and development, international competitiveness, and other issues that impact on the health of the American economy.

Senator **Gorton**. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman. I'll just make one comment. I congratulate you and Senator Garn on conducting these hearings because some wise man said over 100 years ago: "The power to tax is the power to destroy." And I think we should look at this tax bill very, very carefully.

Senator GORTON. Thank you.

Gentlemen, it's 10:17 a.m. and we've already gotten the witnesses here. I think that sets some kind of record for this committee. We are delighted to have you here.

Mr. Mack, we will begin with you. Then we will simply go across the table, listening to your opening statements; then we will question you. In the case of each one of you, his written statement will be included in the record as if read in full. We would greatly appreciate your summarizing those statements so that we will have time for questions.

If you don't summarize well enough, the Chair announces that, after 10 minutes, you will be cut off. So we will start with you, Mr. Mack, and I hope you can meet our challenge.

STATEMENT OF JAMES H. MACK, PUBLIC AFFAIRS DIRECTOR, NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION

Mr. MACK. Good morning, Mr. Chairman. My name is Jim Mack, public affairs director for the National Machine Tool Builders' Association. As you know, our industry represents a small but strategic segment of our Nation's basic manufacturing capacity.

We do appreciate this opportunity to discuss the impact of H.R. 3838 on the competitiveness of the U.S. manufacturing industry.

DECLINE IN MACHINE TOOL INDUSTRY

When we last appeared before this committee in 1985, we expressed our great concern regarding the decline in the industry's competitive position in both foreign and domestic markets. Our competitive problems and those of our customer base will be further exacerbated by the enactment of H.R. 3838. Let me explain why this is so.

Much of the industry's customer base, which is composed of the automotive, aerospace, farm and mining equipment, and fabricated metal products industry, is slowly but perceptibly moving offshore, primarily in an effort to reduce labor and production costs within that shrinking customer base.

The machine tool industry is capturing steadily lower percentages of the domestic market due to high and climbing import penetration. Enactment of H.R. 3838 will intensify both problems, first, by increasing substantially the cost of capital and thereby further pushing our customer base offshore; and, second, by raising the cost of capital to the machine tool industry itself; thus making our industry more susceptible to import penetration and less competitive in overseas markets.

It has been amply documented that American manufacturing industries are facing unprecedented competitive pressure to maintain a viable posture in what is increasingly a hostile global market.

Clearly, continued investment in new productive plant and equipment is essential if the American machine tool industry and its customer base are to mount a credible challenge against foreign competition, both at home and abroad.

Yet, H.R. 3838 will make such investments more costly and therefore less likely to occur in a timely fashion, if at all.

We're not suggesting that investment incentives alone represent a panacea to the competitive problems of basic manufacturing industries. The importance of these incentives should, however, be viewed in the context of what can accurately be described as a hostile international trading environment.

It must be recognized that the investment tax credit and accelerated depreciation schedules are in effect competitive tools which permit manufacturers to make capital investments sooner rather than later—that is, to make those investments which, at the margin, would otherwise be deferred or not made at all.

The availability of this enhancement is crucial during a period in which, competitively speaking, timing is everything.

We are astounded that the House of Representatives, confronted as it was with the overwhelming indications of the floundering competitive standing of U.S. industries and the crucial need for capital incentives to restore competitive momentum, enacted legislation which strikes a disastrous blow to capital formation.

Equally baffling is why the House chose to eliminate investment incentives that have been so demonstrably successful.

History has shown that investment spending is highly responsive to changes in the investment tax credit. We call the committee's attention to exhibits 1 and 2 in our written statement, which chart U.S. industrial productivity and GNP real growth since 1962.

These charts illustrate the ummistakable correlation of the investment tax credit repeal with negative economic results when it has occurred. We firmly believe that if the investment tax credit is eliminated, Congress will come back and reinstate it within 2 years. But, by then, it will be too late. The erosion of U.S. manufacturing capability will be too far along.

The mistakes of the past need not be repeated. The price of repetition could be the permanent loss of U.S. manufacturing competitiveness.

By repealing the 10-percent investment tax credit and by severely restricting accelerated depreciation for equipment, H.R. 3838 substantially increases capital costs for companies which manufacture products in the United States.

As exhibit 3 shows, the bill will cost machine tool customers $3.4 billion in capital cost recovery allowances over the next 5 years.

Machine tools should be depreciated over a period which reflects that the overwhelming majority of today's most productive machine tools are controlled by a computer or other programmable controller. Because electronic technology has evolved far more rapidly than mechanical innovation and invention, machine tool obsolescence has been considerably hastened.

Preliminary estimates indicate that the technology involved in more than 75 percent of the machine tools being sold today did not exist 5 years ago.

The effect of the bill is to actually place machine tool customers in a substantially worse position by $2.5 billion over 5 years than under the pre-1981 ADR system, which everyone agrees provided inadequate capital cost recovery allowances.

BILL WOULD DOUBLE TAXES OVER 5-YEAR PERIOD

The bill doubles taxes paid by machine tool companies over the next 5 years. And this is true notwithstanding the proposed 10-percent corporate rate reduction.

We believe that at least some of H.R. 3838's negative economic and competitive impact could be alleviated if a number of proposals, which we outline on page 12 of our testimony, were to be adopted.

Essentially, what we're suggesting is that you reduce the number of years over which equipment is to be depreciated; that you provide a third year of acceleration; alternately, instead of reducing the number of years, you might wish to provide for a 5-percent investment tax credit for new productive equipment. We suggest permitting all taxpayers, regardless of their asset class, to depreciate machine tools over a 5-year period. Finally, we make some suggestion with respect to transition property and with respect to the minimum tax.

We do not mean to suggest that adoption of these proposals would provide a solution to all of our industry's or our customer base's competitive problems. To the contrary, enactment of these proposals would essentially restore our customer base to the position it was in prior to the enactment of ERTA in 1981.

H.R. 3838, as we mentioned earlier, makes us even less competitive than we were then, at a time when the watchword is restoring competitiveness and reducing the trade deficit.

Thank you, Mr. Chairman. I'd be pleased to respond to your questions.

[The complete prepared statement follows:]

STATEMENT BY
JAMES H. MACK
PUBLIC AFFAIRS DIRECTOR
NATIONAL MACHINE TOOL BUILDER'S ASSOCIATION
BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
FEBRUARY 4, 1986

I. INTRODUCTION AND COMPETITIVE OVERVIEW

Good morning, my name is James H. Mack, Public Affairs Director for the National Machine Tool Builders' Association (NMTBA), a trade association whose member companies account for more than 85% of machine tool production in the United States. As you know, Mr. Chairman, the industry represents a small but strategic segment of the nation's basic manufacturing capacity.

We appreciate this opportunity to discuss the impact of the House-passed tax legislation, H.R. 3838, on the competitiveness of the U. S. machine tool industry -- an industry whose customer base is, in many respects, a microcosm of the heavy manufacturing sector of our economy. As our comments below will illustrate, the impact of H.R. 3838 is profound and undeniably disturbing.

When NMTBA last appeared before this Committee one year ago, we expressed our concern regarding the decline in the industry's competitive position in both foreign and domestic markets. Unfortunately, the industry's cause for concern has reached an even more critical level today. Our competitive problems -- and those of our customer base -- will be further exacerbated by the enactment of H.R. 3838. Let me explain why this is so.

Much of the industry's customer base, which is comprised of the automotive, aerospace, farm and mining equipment and fabricated metal products (in essence, everything from steel to flatware) industries, is slowly but perceptibly moving offshore -- primarily in an effort to reduce labor and production costs. Within that shrinking customer base, the machine tool industry is capturing steadily lower percentages of the domestic market due to high (and climbing) import penetration. Enactment of H.R. 3838 will intensify both problems -- first, by substantially increasing the cost of capital and thereby further pushing our customer base offshore and secondly, by raising the cost of capital to the machine tool industry itself, thus making our industry more susceptible to import penetration and less competitive in overseas markets.

Throughout 1983, while the economy as a whole experienced robust growth, the machine tool industry failed to share in the cyclical expansion. In fact, the industry as a whole lost money in 1983 and 1984, 9.3 percent on sales in 1983 and 3.6 percent on sales in 1984, and it appears that 1985 will be posted as another year of net losses. The implications are obvious. Cost-cutting has been the rule, layoffs of skilled employees have taken place in major proportion, and builders have reduced their capacity to the levels of output prevalent over the past two years. There is little doubt that there has been a substantial reduction in the domestic industry's absolute capacity to produce machine tools. If called on to produce at 1981 levels, for example, the industry would find itself unable to respond with the manpower and capital facilities it currently employs.

A major factor complicating the prospects for recovery is the spectre of further import inroads into the American machine tool market. Imports, measured by value, accounted for more than 43% of 1985 domestic machine tool consumption. Unfortunately, imports have shown every sign of maintaining or increasing this market share.

It is because of the threat of import dominance in the machine tool market, the industrial backbone of American manufacturing and America's defense industries, that early in 1983 the NMTBA filed a petition for import relief with the Secretary of Commerce under Section 232 of the Trade Act of 1962, the National Security Clause. The Commerce Department submitted a reportedly favorable recommendation for action on the Petition to the President on February 28, 1984 -- nearly two years ago. Yet despite overwhelming bipartisan support from Congress for a favorable ruling -- we want to particularly acknowledge the continued leadership and support in that effort of you, Mr. Chairman, and of Senators Proxmire and Heinz -- the Petition remains in the National Security Council and the President still has not acted. Recently, however, White House Chief of Staff Donald Regan indicated that the Petition would come before the Cabinet Council on Economic Policy early in 1986. We are, therefore, anticipating that a decision will be reached within the next few weeks.

It is important to understand that the significance of spiraling machine tool imports goes far beyond the welfare of just the domestic machine tool building industry. If the industry is allowed to be overwhelmed by foreign products, the innovations and new manufacturing process technology that it provides America's manufacturing industries will be lost. Foreign firms will then have

the upper hand in the development of new technology and will be the leaders in the drive toward more cost-efficient production of manufactured goods. The loss of America's machine tool building capability could well signal the beginning of the decline for all of America's metalworking manufacturing industries.

Although the industry is responding to the import challenge through aggressive cost-cutting and accelerated investment in R & D[1], it is unquestionably undergoing a period of competitive realignment. By doubling the rate of taxes paid by machine tool makers over the next five years and by significantly increasing the cost of capital purchases by its customer base, passage of H.R. 3838 will result in the depletion of resources available for R & D. Consequently, R & D spending will, out of necessity, decline. This is true notwithstanding the bill's retention of the R & D tax credit.

Approximately 25 percent of the companies in the industry in 1981 have left it through mergers and liquidations or by changing what they produce. An estimated one-half of the industry imports parts, components or complete machines for resale in the U. S. Additionally, many builders are seeking offshore partners for cooperative ventures. Increasingly, U.S. companies are establishing manufacturing ties with overseas builders for the purpose of penetrating third markets. While such moves may add revenue to the

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[1] The machine tool industry ranked fourth among U.S. industries in R & D spending growth in 1984. Business Week, July 8, 1985, at 86.

U.S. company, the result is a reduction in U.S. capacity.

We have repeatedly acknowledged that the industry is going to survive by taking whatever actions are necessary. But by increasing our nation's reliance on foreign sources for critical items like machine tools, we are unnecessarily increasing the threat to our defense base. Our principal concern with H.R. 3838 is that its passage will hasten that reliance by substantially increasing the cost of capital for American industry, thus causing an even higher share of U.S. productive capacity to move offshore.

II. CAPITAL FORMATION IS ESSENTIAL TO INTERNATIONAL COMPETITIVENESS

The competitive challenges confronting the U.S. machine tool industry are representative of what many basic domestic industries have experienced in recent years. In addition, the integration of computer technology with metalworking equipment has revolutionized basic manufacturing processes.

These developments have combined to exert unprecedented competitive pressure on American manufacturing industries struggling to maintain a viable posture in what is, increasingly, a global market. The adverse competitive impact is readily apparent when viewed in terms of the machine tool industry's shocking deterioration in export performance. Exports by machine tool makers exceeded $1 billion in 1981; by 1985, the industry's exports had fallen to approximately $400 million -- a decline of 60 percent.

Clearly continued investment in new productive plant and equipment is essential if the American machine tool industry and its customer base are to mount a credible challenge against foreign competition -- both at home and abroad. Yet H.R. 3838 will make such investments more costly and, therefore, less likely to occur in a timely fashion, if at all. We are not suggesting that investment incentives alone represent a panacea to the competitive problems of basic manufacturing industries. The importance of such incentives should, however, be viewed in the context of what can accurately be described as a hostile international trading environment.

It must be recognized that the investment tax credit (ITC) and accelerated depreciation schedules are, in effect, competitive tools which permit manufacturers to make capital investments sooner rather than later -- that is, to make those investments which, at the margin, would otherwise be deferred or not made at all. The availability of this enhancement is crucial during a period in which -- competitively speaking -- timing is everything.

The President's Commission on Industrial Competitiveness has recognized the importance of productive capital and recently recommended that "we must more aggressively update our capital stock and provide all members of our work force with the plants and equipment they need to match the productivity improvements of their competitors abroad."[2] In this regard the Commission observed:

> Capital is the fuel for our economic machine. Invested in productive assets like buildings and machines, capital provides the tools we need to compete. Invested in research and development,

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[2] "Global Competition: The New Reality," The Report of the President's Commission on Industrial Competitiveness, at 25. (1985, Vol. I).

> it provides the technological advances that are the key to competitiveness.... The productive and creative use of capital is a strong factor in any nation's competitive position.[3]

And, as the International Trade Commission observed in its competitive assessment of the U.S. machine tool industry, foreign competitors have appreciably greater access to capital than do their U.S. counterparts.[4] Passage of H.R. 3838 will simply make a bad situation worse.

These sentiments were echoed by a number of prominent economists appearing last week before the Senate Finance Committee. All agreed that H.R. 3838, by significantly increasing the cost of capital, will further undermine the already shaky competitive posture of U. S. manufacturing industries and their customers.

III. H.R. 3838 IS ANTI-COMPETITIVE AND ANTI-MANUFACTURING

We remain baffled that the House of Representatives -- confronted as it was with overwhelming indications of the floundering competitive standing of U.S. industries and the crucial need for capital investment incentives to restore competitive momentum -- enacted legislation which strikes a disastrous blow to capital formation. Equally baffling is why the House chose to eliminate investment incentives that have been so demonstrably successful.

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[3] *Id.*

[4] Competitive Assessment of the U.S. Metalworking Machine Tool Industry, report to the U. S. International Trade Commission on Investigation No. 332-149, September, 1983, at xi.

History has shown that investment spending is highly responsive to changes in the ITC. We call the Committee's attention to Exhibits I & II which chart U.S. industrial productivity and GNP real growth since 1962. These charts illustrate the unmistakable correlation of ITC repeal with negative economic results -- suspension of the ITC in 1966-67 and again in 1969-71 interrupted the rise of capital equipment share of GNP that began with enactment of the ITC in 1962.

The reinstitution of the ITC in 1971, followed by the 1975 increase from 7 percent to 10 percent, have raised the capital equipment share of GNP to the highest levels of the past half-century. This investment surge was, of course, disrupted during periods of the extraordinary energy crises in 1973-74 and 1979-80 and during the recent severe recession.

NMTBA firmly believes that -- based upon historical Congressional recognition of the contribution made to investment growth by the ITC and the reduction in capital spending when it has not been in effect -- if the ITC is eliminated, Congress will reinstate it within two years. But by then it will be too late -- the erosion of U.S. manufacturing capability will be too far along. The mistakes of the past need not be repeated. The price of repetition could be the permanent loss of U.S. manufacturing competitiveness.

By repealing the 10% investment tax credit and by severely restricting accelerated depreciation (ACRS) for equipment, H.R. 3838 substantially increases capital costs for companies which manufacture products in the United States.

As Exhibit III indicates, the bill costs machine tool customers $3.4 billion in capital cost recovery allowances over the next five years -- partially by repealing the ITC and partially by increasing from five to ten or more years the period of time over which machine tools can be depreciated.

The House bill -- like the pre-1981 ADR system -- places all *taxpayers* in certain asset classes for depreciation purposes. The amount of depreciation taken by the taxpayer will be determined by this classification -- *regardless* of the type of asset being depreciated. The legislation -- like the pre-1981 ADR system -- permits some types of assets to be depreciated over shorter periods irrespective of the taxpayer's asset class -- special tooling and equipment over three years and computers over five years.

We believe that machine tools should be similarly depreciated over a five-year period, reflecting the fact that the overwhelming majority of today's most productive machine tools are controlled by a computer or other programmable controller. As a result, the design, manufacture and application of both individual machines *and* systems are tied directly to the state-of-the-art of the computer or programmable control itself. This integration of technologies extends not only to the machines and controls, but to auxiliary functions such as those performed by robotics and sensing devices. Because electronic technology has evolved far more rapidly than mechanical innovation and invention, machine tool technological obsolescence has been considerably hastened. Preliminary estimates indicate that the technology involved in more than 75 percent of the machine tools being sold today did not exist five years ago.

Why should machine tools be accorded "special" depreciation treatment? As we noted earlier, machine tools serve as the foundation for virtually all manufactured products. The ability to remain on the cutting edge of metalworking technology and productive processes is, from a competitive standpoint, absolutely crucial. The distinction between what works and what works *best* makes all the competitive difference for the U.S. machine tool industry and its customers.

The House chose to refer this issue to the Treasury Department for further study. NMTBA believes that the competitive implications of this proposal represent a fundamental policy decision properly within the purview of the Congress -- it should not be relegated to an administrative agency.

The effect of the bill is to actually place machine tool customers in a substantially *worse* position ($2.6 billion over 5 years), than under the pre-1981 ADR system, which everyone agreed provided inadequate capital cost recovery allowances.

The bill doubles the taxes paid by machine tool companies over the next five years. This is true *notwithstanding the proposed 10% corporate rate reduction* (actually, since the corporate rate reduction does not become effective until July 1, 1986, the "blended" corporate rate over the next five years is 37%). As a matter of fact, one might argue that the lower rate of tax on corporate income (regardless of the source of its generation), coupled with totally inadequate capital cost recovery provisions, actually hastens the movement of manufacturing capacity offshore, thus increasing imports and further depleting the industrial base so critical to our national security.

In addition, the small (eleven point) differential between the 36% regular corporate tax rate and the 25% alternative minimum tax rate is likely to cause the deferral or indefinite postponement of many capital investment decisions, because corporations will be unwilling to run the risk of putting themselves into a minimum tax position, from which they would never be able to "escape." If a minimum tax is to be used to facilitate "fairness," great care must be taken to assure that the tax rate and base do not overly increase complexity nor retard economic growth and international competitiveness.

In this regard, we should note that most of the minimum tax proposals introduced in the Senate include R & D expenditures as a "preference item" to be included in the alternative tax base. Fortunately, H.R. 3838 does not do so, for the inclusion of R & D expenditures as a minimum tax preference item runs counter to accepted accounting procedures for "booking" such items and would further deplete a key international competitive tool. It would also have the effect of placing many small manufacturing companies in a minimum tax position - a result which, we are sure, the sponsors of those proposals did not intend.

NMTBA, along with other members of the Invest to Compete Alliance (a broad-based coalition of companies and trade associations formed in an effort to retain crucial capital cost recovery provision), believe that at least some of H.R. 3838's negative economic and competitive impact could be alleviated if the following proposals are adopted:

- Retain 200% Declining Balance Method in H.R. 3838;
- 3rd year of acceleration (i.e., move from 200% declining balance in years 1 and 2 to sum-of-the-years digits in year 3 to straight line in year 4 and thereafter);
- reduce number of years over which equipment is to be depreciated;

  OR

  provide 5% ITC for new productive equipment;
- eliminate mid-month convention penalty for taxpayers who acquire 40% of their assets in 4th quarter;
- permit all taxpayers -- regardless of their asset class -- to depreciate machine tools over 5 years;
- permit full use of 10% ITC in year transition property is put into service (H.R. 3838 stretches out the 10% ITC a transition property over 5 years);
- uncertainty regarding the effective dates issue should be resolved as quickly as possible in order to provide a more stable investment climate;
- permit all taxpayers to use ITRC carry-forwards against minimum tax liability;
- keep depreciation and R&D out of minimum tax base;
- keep transition property out of minimum tax base; and
- if depreciation is included in minimum tax base, use straight line over the period applicable under the regular tax as the "baseline," instead of using earnings and profits "baseline."

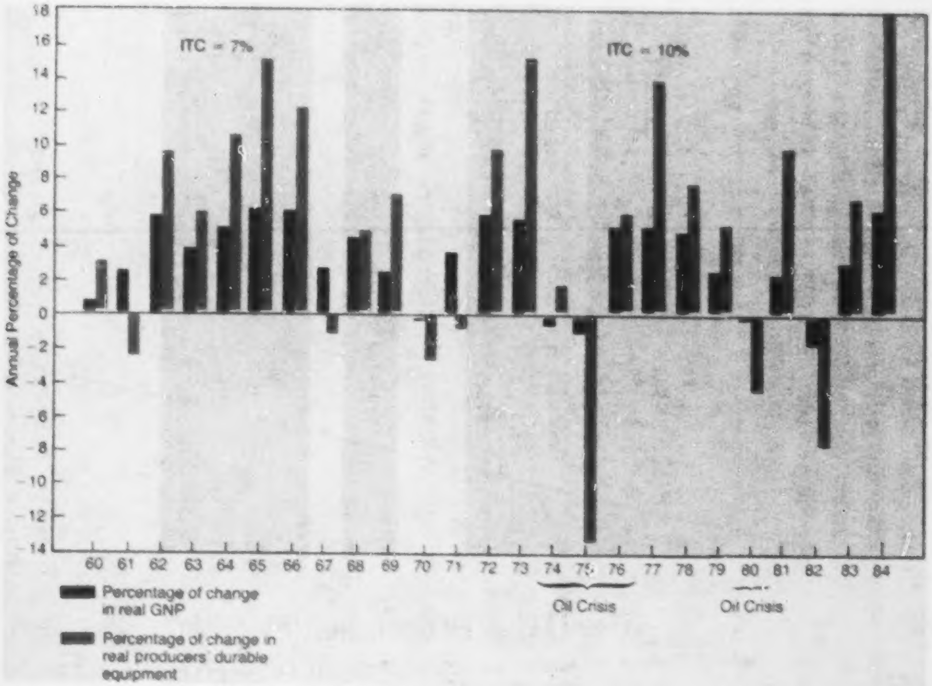
We do not mean to suggest that adoption of these proposals would provide a solution to all of the industry's competitive problems.

EXHIBIT I

The Stimulating Effect of ITC

Rates of Growth in Real GNP and Real Producers' Durable Equipment

- The rates of growth for GNP and producers' durable equipment react directly to ITC.



To the contrary, enactment of these proposals would roughly restore us to the position we were in prior to the enactment of ERTA in 1981. H.R. 3838, as we mentioned earlier, makes us even less competitive than we were then -- at a time when the watchword is restoring competitiveness and reducing the trade deficit.

IV. CONCLUSION

Our present competitive posture serves as a painful reminder that there is a continuing, critical need for capital formation in the United States. Recent economic gains have not obviated that need. If H.R. 3838 is enacted into law, the irreversible erosion of U.S. manufacturing capability will be all but assured. We all look forward to the return of U.S. industries to a meaningful competitive presence in foreign and domestic markets. H.R. 3838 will lead us in the opposite direction.

EXHIBIT III

IMPACT OF VARIOUS PROPOSALS ON DEPRECIATION OF
$4 BILLION ANNUAL MACHINE TOOL SALES
(ASSUMING 36% CORP. RATE)*

YEAR	ADR[1]	ACRS[1]	TREASURY[2]	HOUSE
1	$ 568,480	$ 605,200	$158,400	$144,000
2	324,000	300,960	281,950	288,000
	$ 892,480	$ 906,160	$440,350	$432,000
3	233,280	287,280	219,230	111,500
	$1,125,760	$1,193,440	$659,580	$543,500
4	116,640	287,280	171,690	111,500
	$1,242,400	$1,480,720	$831,270	$655,000
5	116,640	287,280	152,180	111,500
	$1,359,040	$1,768,000	$983,450	$766,500
5-year tax benefit	$5,188,180	$5,953,520	$3,073,050	$2,541,000

*In thousands of dollars

Year in which $1,440,000 is recovered[3]	6	4	8	11

[1] Includes 10% ITC

[2] Does not include indexing

[3] $1,440,000 is full depreciation of $4,000,000 worth of assets at 36% corporate rate

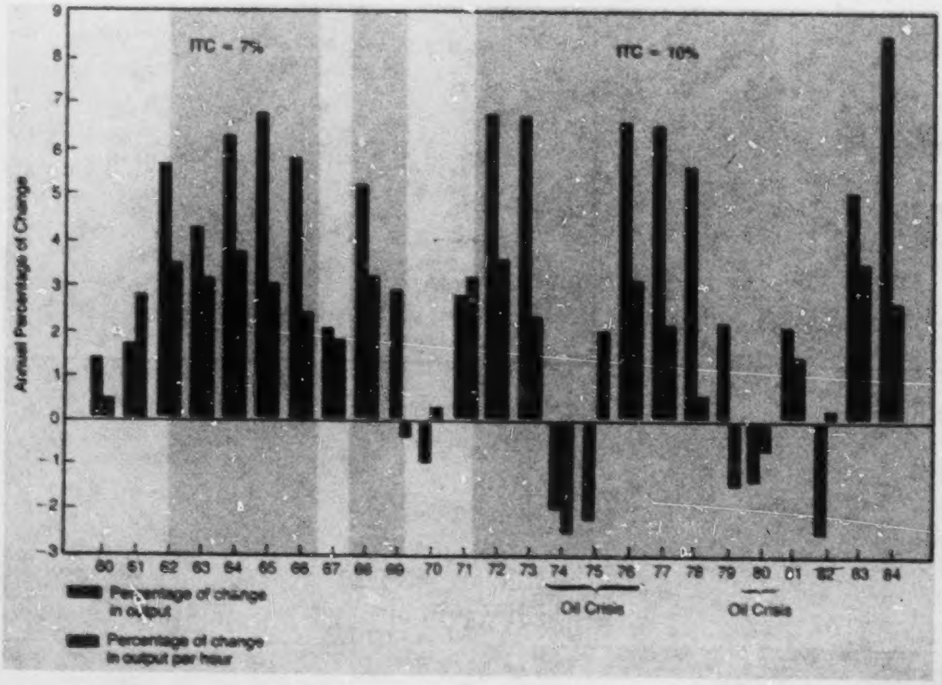
House Bill costs machine tool customers $3.4 billion in capital cost recovery allowances over the next five years (including $400 million per year from ITC repeal)

The ITC & Productivity

EXHIBIT II

Rate of Change in Output and Rate of Change in Output per Hour

- ITC stimulates gains in productivity.
- Increases or decreases in the rate of change in output per hour or production result in increases or decreases in the rate of change in output.



Senator GORTON. Thank you for a very forceful and effective statement. I appreciate it.

Mr. Huard.

STATEMENT OF PAUL R. HUARD, VICE PRESIDENT, TAXATION AND FISCAL POLICY, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. HUARD. Thank you, Mr. Chairman. I'm Paul Huard, vice president for taxation and fiscal policy of the National Association of Manufacturers. I'm pleased to be here this morning to present the views of our more than 13,000 manufacturers on H.R. 3838.

Our written statement sets forth in moderately excruciating detail our numerous objections to the bill, so I'll try to be mercifully brief and to summarize it quickly. Our concern is on two levels.

BILL INCREASES CORPORATE TAXES $140 BILLION OVER A 5-YEAR PERIOD

We have a generalized and a particularized concern. The generalized concern is at the macroeconomic level. Essentially, what you have here is a bill that over 5 years increases corporate taxes by $140 billion and uses that to decrease individual taxes by $140 billion, a very politically attractive proposition.

However, when analyzed on a macroeconomic basis, there is a startling amount of unanimity in the views of people doing the analysis. The analysis that we commissioned showed the result of this—over 5 years—would be a lower GNP, lower business investment, greatly increased cost of capital, higher unemployment, higher deficits, higher imports. The import problem is particularly troublesome.

I am encumbered with a legal education so I don't do anything with macroeconomic forecasting other than report it. But studies show, and it seems to be common sense, what we have to tell you, that if you take $140 billion and pump it into the consumer sector, it's not likely to dramatically increase the savings rate. We did that in the 1981, 3-year, 25-percent tax cut.

In this case, it's particularly unlikely to increase the savings rate because of the countervailing effect of punitive treatment of IRA accounts and reduced limitations on corporate pension plans, profit-sharing plans, restrictions on 401K plans. One cannot plausibly expect, given the fact that the last major consumer tax cut resulted in lowering the savings rate, that the next one would plausibly raise it.

So, what it's going to go into in all probability is consumption. Now, how do we pay for this stimulus to consumption? By raising business taxes by $140 billion, largely through repeal of accelerated depreciation and investment tax credits. In other words, through techniques that will raise the cost of finished goods manufactured in the United States. So, you have this sort of double-whammy effect.

On the one hand, you're stimulating the demand for consumer goods; on the other hand, you're impairing the ability of American-based producers to meet that demand with competitively priced products.

I didn't have to get a degree in economics to figure that out. It's a distressingly obvious result of this bill. Obviously, our generalized concern is specific enough, but our particularized concern relates to the fact that we are an association of manufacturers.

We feel that a large part of the burden of this bill is going to fall on our side. Obviously, the $140 billion corporate tax increase is a net figure. Within that universe, there are winners and losers.

Again, if you look at the provisions of the bill, it's not hard to figure out where the concentrations lie. Most of the winners are in the noncapital intensive sector, the retail sector, the service sector—some manufacturers.

The losers are the people who are going to feel most heavily the burden of those repeals that are financing all this wonderful reform process. That's largely those people who rely heavily on the investment tax credit and accelerated cost recovery.

To a lesser extent, it also includes people who have multinational operations, who are losing substantial amounts of money due to the changes in the foreign tax credit rules.

So, again, I think that, both on the general level and in terms of looking at the macroeconomic effects of this bill, and on the particularized level, looking at its predictably adverse effect on manufacturers, it's an extremely unfortunate bill.

Our recommendation is that the bill not be enacted at all. We would hope that this committee would recommend to its colleagues on the Finance Committee when proceeding with the reform process that they start from scratch and design their own reform vehicle. This one is irreparably flawed.

I hope I came in under the 10-minute rule.

[The complete prepared statement follows:]

STATEMENT OF PAUL R. HUARD

VICE PRESIDENT, TAXATION AND FISCAL POLICY

ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

ON H.R. 3838

FEBRUARY 4, 1986

I am Paul R. Huard, Vice President for Taxation and Fiscal Policy of the National Association of Manufacturers (NAM).

NAM is a voluntary business association of over 13,500 companies, large and small, located in every state. Our members range in size from the very large to over 9,000 small manufacturing firms that each have less than 500 employees. NAM member companies employ 85% of all workers in manufacturing and produce over 80% of the nation's manufactured goods. NAM is affiliated with an additional 158,000 businesses through its Associations Council and the National Industrial Council.

On behalf of our members, I am pleased to be here today to express the Association's views on the Tax Reform Act of 1985 (H.R. 3838).

I. INTRODUCTION

The tax simplification plan contained in H.R. 3838 represents the third in a series of tax simplification proposals which would overhaul the tax code by lowering individual and corporate rates while removing major deductions, exclusions and credits. Reduced to the essentials, the House bill has the following effects:

1. The distribution of tax liabilities is shifted toward corporations. In this respect, whatever its ostensible commitment to increasing the "neutrality" of the tax code, H.R. 3838 is not neutral between individuals and corporations.

2. While H.R. 3838 simplifies the tax system for a few individuals , it further complicates it for many other taxpayers—including virtually all businesses—and it fails to address other elements in the tax code which are in need of reform. For example, rather than rectifying the existing biases of the tax code toward consumption, it exacerbates these biases.

3. The macroeconomic implications of the bill are highly adverse. Econometric simulations cited below demonstrate that the bill would significantly raise the user cost of capital. This in turn would translate into lower business investment, lower productivity, lower aggregate growth and higher unemployment. The economy becomes more labor-intensive and more service-intensive. In essence, H.R. 3838 would tend to engender a process of deindustrialization.

This statement consists of five major sections. Part II examines the shift in tax liabilities from individuals to corporations and the implications of further subsidizing consumption in a tax system that is already heavily biased in favor of consumption and against savings. Part III analyses the impact of the tax reform proposals on the user cost of capital. Part IV examines the impact on the overall economy, using econometric simulations of the House tax bill (H.R. 3838) and alternative monetary policy assumptions. Part V compares the projected changes in the depreciation laws with capital cost recovery systems in other major industrial countries. Part VI examines certain changes in the bill regarding the treatment of domestic and foreign source income.

II. THE TAXATION OF INVESTMENT AND CONSUMPTION

2.1 Taxation of Individuals and Corporations.

The rationale for shifting the tax burden onto the corporate sector remains obscure, apart from the obvious political benefits of lowering individual taxes. Historically, corporations have paid a considerably greater share of their income in taxes than individuals. Disregarding for the moment contributions for social insurance and state and local taxes, the ratio of Federal income tax liabilities to corporate profits (adjusted for capital consumption and inventory valuation) has varied between a peak of 55.9% in the early 1950s and as high as 54% as recently as the late 1970s, with a low of 33.6% in 1983, averaging well over 40% for the postwar period. By comparison, individual payments of Federal income tax in relation to personal disposable income have averaged in the area of 11% to 12%. In other words, the ratio of Federal income tax to income has been roughly three times as large for corporations as for individuals.

Part of the spurious rationale cited by advocates of tax "reform" for raising taxes on corporations is that the share of Federal revenue derived from corporations has undergone a decline since the early 1960s. However, this ignores two factors. First, an increasing share of corporate pre-tax cash flow has been devoted to social security tax payments. Secondly, the share of national income attributable to pre-tax corporate profits has also undergone a chronic decline since the 1960s. The ratio of corporate profits to national income fell from 14.0% in 1965 to 6.5% in 1982, recovering to only 8.5% in 1983. In this respect, the decrease in the share of Federal revenue derived from corporations is primarily a reflection of decreases in the share of GNP comprised by corporate profits.

A further reason for not raising corporate taxes as proposed in H.R. 3838 has to do with the level of real corporate profits. From 1966 onward, real corporate profits in constant dollars declined consistently until the late 1970s. Real profits only surpassed their 1966 level in 1978. Thereafter, profits fell consistently until 1983. In 1982, real after tax profits were more than 30% below their 1978 level. Thereafter, the implementation of ACRS has been critical in restoring higher levels of profitability. By 1983, profits had regained their 1978 level. However, this was only 7.5% higher than their level of 1966. The evidence is therefore that the American economy has undergone a serious long term erosion in real profits over the past two decades. It is partially as a result of corporate tax cuts such as ACRS that this erosion has been reversed, although other factors such as the recovery itself were also involved. Raising corporate taxes by the magnitudes proposed in H.R. 3838 would exacerbate the long-term problem of depressed profitability.

2.2 Changes Within the Corporate Sector.

Within the corporate sector, the major implication of H.R. 3838 is to shift the distribution of liabilities toward more capital-intensive firms while reducing taxes on service-oriented or non-capital intensive companies. The equally spurious rationale underlying this distributional change has to do with the current inequality in tax liabilities across sectors. Firms which are unable to take advantage of accelerated depreciation or tax credits are likely to pay taxes at or near the statutory maximum. Conversely, corporations that possess larger volume of depreciable assets have been able to reduce their taxes substantially below the maximum rates. However, it should be noted in this context that shifting to an income-based system of corporate taxation with fewer investment subsidies is likely to work against capital formation. Several recent econometric studies have demonstrated a statistically significant relationship between the ITC, changes in depreciation, and business fixed investment. Further, the ability of targeted investment incentives to stimulate capital formation is considerably greater than general, diffuse, non-targeted measures such as rate reductions. Accelerated depreciation and the ITC have been estimated to provide a rate of return in investment in the area of 75% to 85%, while a corporate rate cut generates an increase in investment of less than 20%. In this respect, the need to retain investment subsidies is underlined by the fact that the United States has had one of the lowest ratios of fixed investment to GNP among the industrial countries.

2.3 Taxation of Income and Consumption.

While H.R. 3838 has been billed as a major reform of the tax system, it completely fails to address one crucial element in the tax code, the distribution of taxes relative to income and consumption. Historically, the tax system in the United States has been heavily weighted toward taxing income rather than consumption. Of total revenues received by the Federal, state and local governments in 1981, some 46.2% was derived from income taxes while only 17.6% was derived from consumption taxes (the remainder is comprised primarily by social insurance contributions). By comparison, the proportions are substantially more weighted toward consumption in other industrial countries. The share of revenues derived from consumption taxes in 1981 ranged from 24% in Italy and the Netherlands to 27% to 29% in Germany, France and the United Kingdom, and 33% in Canada. Similarly, the share of revenues derived from income and profits taxes in the other industrial countries has typically been much lower than in the United States. For instances, in Germany, 29% of revenues are derived from personal income taxes and 5% from corporate taxes (a total of 34%), while in France 13.3% are derived from personal income taxes and 5% from corporate profits, a total of 18.3%.

The accompanying table gives the share of total taxation comprised by income and consumption taxes, and the ratio of consumption to income taxes in nine OECD countries for the period 1977-79. The United States has clearly had a tax system that encourages consumption to a far greater degree than tax codes overseas.

Taxes on Income and Consumption, Industrial Countries, 1977-79

Country	Income Taxes % of Total	Consumption Taxes % of Total	Ratio, Consumption Tax to Income Tax
France	18.0%	31.0%	172.2
Austria	26.3	32.3	122.8
Germany	35.8	36.3	101.4
Italy	29.7	28.2	94.9
Netherlands	32.7	25.6	78.3
Canada	45.0	32.3	71.8
United Kingdom	40.3	26.5	65.8
Belgium	40.7	26.4	64.9
United States	46.2	16.9	35.5

Source: Grace Commission

Further, there is an inverse relationship between the propensity to tax consumption and the personal savings rate. Of the countries listed above the savings rate for the period 1977-79 was only 6.2% in the United States, compared to 15.0% in Austria, 14.1% in Italy, 14.0% in Germany, 13.5% in the Netherlands, 13.1% in France, 11.7% in Belgium and 11.4% in Canada. While other factors also determine savings rates, the tax system in the United States has repeatedly been demonstrated to be partially responsible for the low savings rate in this country.

The failure of either H.R. 3838 or the anteceding Treasury proposals to address the problem of excessive taxation of consumption relative to income represents a major shortcoming. In essence, while H.R. 3838 purports to achieve a sort of neutrality across sectors (provided the term "neutrality" is defined with sufficient looseness), it is not neutral on the consumption-income issue. The House bill further skews the tax base toward income, and in this sense can be viewed as an implicit consumption subsidy.

III. THE EFFECTS ON THE COST OF CAPITAL

In order to gauge the effect of the House tax reform bill (H.R. 3838) on the cost of capital, NAM commissioned a study from Fiscal Associates, Inc. The conclusions given here and the Tables in Appendix I are based on that study. In the following, the cost of capital is defined as the current gross expenditure required to produce an additional dollar of real investment at constant tax rates. The estimates cover depreciable, tangible assets only, and exclude the cost of inventories and natural resources.

3.1 Overall Impact

H.R. 3838 is estimated to raise cost of corporate nonresidential depreciable capital by 9.2 percent. H.R. 3838 contains a provisions that phases in a dividend deduction at the corporate level of 1 percent per year beginning in 1987 for 10 years. The dividend deduction helps alleviate the impact of H.R. 3838 on the cost of capital, although this will not be complete until 1996. The increase in the cost of capital with fully phased-in 10 percent deduction is 5.4 percent. The impact of H.R. 3838 on the cost of noncorporate capital is even worse. This sector is not helped by either the reduction in corporate tax rates or by the dividend deduction. H.R. 3838 increases the cost of noncorporate capital by 12.3 percent.

H.R. 3838 includes a number of important changes in accounting rules for long-term contracts and self-constructed assets. These changes are not included in the calculation of the estimates just represented, and would increase corporate capital costs by an additional 3.6 percent, to 8.9 percent with the dividend deduction and 12.9 percent without that provision. These changes increase the cost of noncorporate capital by 14.3 percent.

A long-run economic analysis of H.R. 3838 implies a 2.0 percent reduction in the level of real GNP. This results in a permanent addition to the federal deficit, when measured as a proportion of GNP, of 0.5 percentage points. The international competitive position of the United States sharply deteriorates under H.R. 3838.

3.2 Impact by Asset Category

Table 1, Appendix I shows the impact of H.R. 3838 without the dividend deduction provision by asset category. Equipment is the hardest hit with its cost increasing by 12.3 percent. The cost of buildings, the predominant type of structure, essentially remains unchanged. Other categories of structures face increases averaging 9.8 percent.

Table 2, Appendix I shows the impact with the fully phased-in dividend provision, again not occurring until 1996. The cost of equipment increases by

8.3 percent and non-building structures by 6.0 percent. The cost of buildings actually declines by 3.5 percent.

3.3 Impact by Industry

Table 3, Appendix I shows the impact of H.R. 3838 without the dividend deduction by industry. Major industry categories facing the largest increases in capital costs include agriculture, manufacturing, and transportation.

Table 4, Appendix I shows the impact with the full 10 percent dividend deduction. Although the size of the cost increase is less, the differential impacts by industry remain the same as without the deduction. No industry category achieves a decline in its cost of capital under H.R. 3838.

3.4 Impact by Selected Provision

Tables 5, 6 and 7, Appendix I, reveal the differential impacts of selected provisions in H.R. 3838. The first column in Table 5 shows the corporate cost of capital by asset category under present law. The second column measures the cost of capital when the investment tax credit (ITC) is removed. The third column shows the cost of capital when, in addition to removal of the ITC, ACRS depreciation is replaced with H.R. 3838's "Incentive Depreciation System". The last three columns include successively the corporate rate reduction, the personal rate reduction, and the 1996 dividend deduction.

The incremental impacts of the provisions applied successively, beginning with the removal of the ITC, is shown in Table 6. Cumulative impacts are given in Table 7. The provision with the largest impact is the removal of the ITC. It increases the cost of equipment by 16 percent, structures by 3.5 percent, and nonresidential fixed investment by 11.8 percent. The proposed change in depreciation write-offs further increases the cost of nonresidential fixed capital by 5.3 percent, the largest increases occurring for structures. Thus, the two provisions which specifically affect the tax treatment for new investment raise the cost of capital by 17.8 percent. The increase is slightly higher for equipment.

The increase in the cost of capital resulting from the removal of the ITC and depreciation changes is only partially offset by corporate and personal rate reductions. The drop in the average marginal corporate tax rate from 46 percent to 36 percent offsets 6 percentage points of the increase due to the ITC and depreciation changes. The slight drop in the average marginal personal dividend tax rate offsets another 1.4 percentage points. The fully phased-in 10 percent dividend deduction at the corporate level, scheduled to take effect in 1996, offsets another 3.5 percentage points. Thus, H.R. 3838 raises the overall cost of nonresidential fixed investment by 9.2 percent without the 1996 deduction and by 5.4 percent with that deduction.

3.5 Impact on the Cost of Noncorporate Capital

The preceding analysis focuses on corporate capital. The impact of H.R. 3838 on the cost of noncorporate capital, however, is even worse. The ITC and depreciation provisions apply to both the corporate and noncorporate sectors. The noncorporate sector, however, is not helped by either the reduction in the corporate tax rate or the dividend deduction. Its relief comes solely from the small reduction in marginal tax rates at the individual level.

Changes in the cost of noncorporate capital by asset are given in Table 8 and by industry in Table 9. H.R. 3838 increases the cost of noncorporate capital by 12.3 percent overall. The cost of equipment and other structures increase by about 14 percent and buildings increase by 6.6 percent. The relative impacts by noncorporate industry are similar to those for the corporate sector.

3.6 Accounting Rule Changes

H.R. 3838 includes a number of important changes in accounting rules for long-term contracts and self constructed assets. Current rules effectively allow some deferral of tax and the expensing of a portion of indirect costs. The rules under H.R. 3838 eliminate these opportunities to reduce the tax burden on capital. Overall, the present low cost of capital for nonresidential depreciable capital is actually 3.3 percent less than that shown in Table 5. This implies that H.R. 3838 increases the corporate capital cost by 8.9 percent with the dividend deduction and 12.9 percent without that provision. The increase in the noncorporate capital cost including the accounting changes is 14.3 percent.

3.7 Long-Run Economic Implications

A change in tax law generates changes in the demands and supplies of output, labor, and capital. The long run economic implications of H.R. 3838 can be estimated under the assumption that all needed economic adjustments are completed. H.R. 3838 reduces aggregate U.S. output by 2.0 percent below the level achievable under current law. This results in a permanent addition to the federal deficit, when measured as a proportion of GNP, of 0.5 percentage points. Presumably taxes would have to be raised to bring the government accounts into balance, compounding the slowdown in growth.

The short-run impact of H.R. 3838 on investment is far more detrimental and depends on how rapidly the economy can change its mix of production to the dramatically different tax environment. Using the long-run estimates, a conservative forecast of the loss in output by 1990 is over $300 billion in 1985 dollars. Nearly $100 billion in 1985 dollars will be added to the national debt. The amount of deficit reduction required by Gramm-Rudman will increase from about $35 billion a year to $40 billion a year.

The higher cost of capital lowers the capital stock by 1.6 percent, labor productivity by 1.9 percent, and the number of jobs by 100,000. The real after-tax wages of labor fall by 0.3 percent in spite of the reductions in personal tax rates. The differential impact on the components of capital causes a marked shift away from equipment and the smokestack industries. The trend towards greater reliance on service sector jobs is intensified.

The competitive position of the United States sharply deteriorates under H.R. 3838. The increased taxes on U.S. manufacturing are reflected in higher prices for U.S. goods relative to those of foreign competitors. The reductions in the cost of capital for inventories at the wholesale and retail levels do not aid U.S. goods vis-a-vis imports because the improved treatment generally extends to foreign goods sold here as well.

In essence, H.R. 3838 has the immediate impact of raising the cost of capital at the corporate level by nearly 13 percent and over 14 percent for the noncorporate sector. Increasing the cost of capital means less investment by U.S. firms and a slower growing capital stock. A slower growing capital stock means less capital per worker, lower productivity, and slower growth in real wages. Indeed, after-tax wages decline under H.R. 3838, in spite of the reduction in personal tax rates. Less output results in a smaller tax base than occurs under present law, all other things the same. After full economic adjustment, real GNP is reduced by about 2.0 percent under H.R. 3838, and the federal deficit increases as a percentage of GNP.

The increase in the cost of U.S. capital undermines the U.S.'s competitive position vis-a-vis its trading partners. For example, the current U.S. tax system raises the corporate cost of capital by 16 percent over the Japanese system. This differential increases to 25 percent under H.R. 3838, even with a fully phased-in dividend deduction and neglecting the impact of the accounting rule changes.

IV. IMPLICATIONS FOR THE AGGREGATE ECONOMY

In order to gauge the impact of tax reform on the aggregate economy, in an independent study not commissioned by NAM, the Washington University Macromodel was simulated out to 1991, and the results were compared with the baseline forecast for the same period by the Congressional Budget Office (CBO). The results of these simulations are presented in Appendix II. Simulation #1 gives the CBO baseline. Simulation #2 gives the effects of H.R. 3838 with the assumption of no accommodation by the Federal Reserve. Simulations #3, 4 and 5 compare the effects of H.R. 3838 under varying degrees of accommodation with and without simultaneous changes in the money demand function.

4.1 The CBO Baseline

The CBO baseline forecast yields a trend of approximately 3 percent growth per year from 1986 to 1991 in real GNP. This is not meant to imply a total absence of business cycles; rather, the yearly growth rates represent averages over the cycle. In the same simulation, fixed investment also grows at a pace of somewhat more than 3.5 percent per year, with larger increases registered in producer durables in every year except 1987. The inflation rate averages just under 4 percent per year, while the unemployment rate falls steadily to 5.4 percent. The Federal deficit increases to $308.4 billion (the simulation was passed before the adoption of the Gramm-Rudman deficit reduction plan). Both nominal and real interest rates remain relatively constant. The rental price of investment falls initially and then levels off.

4.2 Tax Reform without Monetary Accommodation

Table 2, Appendix II presents an econometric simulation of the effects of H.R. 3838 with no monetary accommodation. In this simulation, the Federal Reserve holds the growth rate of nonborrowed reserves constant, providing no monetary offset to the contractionary effects of the tax bill. This represents the closest possible approximation of the "pure" effects of H.R. 3838, with no other policy changes. The effects may be briefly summarized.

Lower Growth The growth rate of real GNP is lower by magnitudes of up to -1.5 percentage points per year relative to the CBO baseline forecast for the economy.

Lower Capital Formation Fixed investment is lower by up to -2.5 percentage points annually. Investment in producer durables is lower by up to -2.5 percentage points, nonresidential structures by up to -2.8, and residential structures by over -1. The real capital stock in producer durables is lower by over $100 billion (in constant 1972 dollars).

Higher Unemployment The civilian unemployment rate is 1.3 percentage points higher than in the baseline, *i.e.*, by 1991, the unemployment rate is 6.7 percent, compared to 5.4 percent in the baseline.

Larger Deficits The Federal deficit would be $25.2 billion larger in 1991 than in the baseline. The major causes are the undercutting of revenues by lower growth, and pressure for higher transfer payments due to higher unemployment.

Sectoral shifts Away From Investment Under current law, baseline gross fixed investment reaches 18.3 percent of GNP in 1991; under the Ways and Means proposal, the investment share falls to 16.1 percent of GNP.

Thus without an offsetting reaction by the Federal Reserve, the economy undergoes both significant output losses, higher unemployment and progressive deindustrialization.

Only marginally less deleterious results are obtained in the third simulation, in which the Federal Reserve also does not offset the effects of tax reform, but in which an inward shift in the money demand function (here denoted the "Darby effect") leads to a slight amelioration in the performance of the economy. The money demand function normally makes the growth rate in real money balances (the nominal money supply deflated by the price level) a non-linear positive function of real income and lagged real balances, and a non-linear negative function of real interest rates. One mechanism which could plausibly cause the money demand function to shift inward would be a fall in short-term interest rates relative to long-term rates. In this eventuality, funds would be transferred from the narrow money aggregate M1 into assets such as long-term bonds which pay higher rates of return. The public's demand for money would therefore decline.

In the third simulation, the private sector's demand for money function is assumed to shift inward as a result of changes in income and interest rates. The result is that although absolute money supply growth rates are essentially similar, the deterioration in the economy is less pronounced. The growth rate of real GNP is about two-tenths of a percent higher annually than in simulation #2; the unemployment rate falls to 5.7 percent rather than 6.7 percent, and the growth rate of capital investment is also slightly higher. Nevertheless, the deterioration in the trade sector is actually worse; primarily because higher domestic activity bids up demand for imports. Imports grow by over 3 percent per year, compared with less than 3 percent in the second simulation.

Whether or not the money demand function will shift inward is a moot point. Given the normal specification cited above, while the slower economy and the possibility of an increased differential between long and short-term interest rates would cause the money demand function to shift inward, the corresponding decline in interest rates would produce a countervailing outward shift in the money demand function. Over the last three years, this latter effect has in fact dominated the behavior of money demand, as can be evidenced by a pervasive decline in monetary velocity. Consequently, it cannot be assumed that the money demand function will shift inward sufficiently to allow greater economic activity. For this reason, simulation #2 is to be preferred to simulation #3 as a more realistic portrayal of the path of the economy under a nonaccommodative monetary policy.

4.3 Tax Reform with Monetary Stimulus

In the event that the House bill were to become law, the deterioration in the economy would place considerable political pressure on the Federal Reserve to adopt a looser monetary stance, in order to offset the decline in economic activity.

The fourth simulation in Appendix II presents the results of a constant money supply growth strategy. In contrast to simulations #2 and #3 in which the Federal Reserve holds the growth rate of nonborrowed reserves constant, in this simulation nonborrowed reserves are allowed to grow at whatever rate is necessary to insure a constant growth rate in the money supply M1 at the same rate as in the CBO baseline. This yields a more accommodative result in part because of the slower growth rate of the economy and the resulting assumed shift in the money demand function. The results of this simulation are almost identical to simulation #3. In other words, while the outcomes are preferable to total nonaccommodation, they are still markedly inferior to current law, both in GNP, unemployment and capital formation.

The fifth and final simulation presents the results of a full offsetting reaction by the Federal Reserve. Here, the growth of nonborrowed reserves is raised sufficiently to insure that the economy follows essentially the same growth path as under current law, i.e., the CBO baseline. As can be verified by a comparison of Tables 1 and 5, Appendix II, the trajectories for real GNP are almost identical.

However, in other respects, the simulation results for H.R. 3838, even with full monetary accommodation, are substantially inferior to current law. Notably, the following comparisons are significant.

Lower Investment Investment in producer durables is lower in simulation #5 than in the baseline. A notable result of simulation #5 is an immediate fall in spending on producer durables after implementation of tax reform. Spending on nonresidential structures is also lower than in the baseline. These outcomes follow directly from the higher rental price of capital. In simulation #5, the rental price of investment is nearly two percentage points higher for producer durables than in the baseline, while the rental price for nonresidential structures is also higher on average, particularly in 1987-88. As a result of the decline in investment, the economy undergoes unfavorable changes in the output mix. Thus investment share falls by roughly one percentage point relative to the baseline.

Higher Inflation Both because of faster monetary expansion and lower productivity, the inflation rate increases in simulation #5. By the end of the simulation, the GNP Deflator is rising four-tenths of a percent more rapidly than in the baseline.

Lower External Competitiveness The growth rate of exports is slower in simulation #5, reflecting the diminished efficiency of American producers relative to producers overseas, the higher cost of capital in the United States and the diversion of exportables to the home market due to the shift in the spending mix toward consumption. The same factors, particularly the consumption effects of tax reform, generate higher imports in simulation #5.

4.4 Conclusions

The implications of H.R. 3838 for the economy in the aggregate are uniformly unfavorable. If the Federal Reserve does not undertake an offsetting monetary reflation, the economy undergoes lower growth, lower capital spending, lower exports and higher unemployment. In the "best" possible scenario, in which the Federal Reserve attempts to systematically offset the effects of tax reform through reflation and there is a simultaneous inward shift in the money demand function, the performance of the economy is still inferior to current law: the economy experiences lower capital investment, lower exports, higher imports and higher inflation.

Moreover, it is not clear by any means whether the "best" case could even be realized. For reasons cited above, the likelihood of the shift in the money demand function is problematical. Secondly, there are serious constraints on the ability of the Federal Reserve to provide a full offset to the adverse changes in tax policy. The faster rate of monetary growth required to offset tax reform could set off a much faster acceleration in inflation than that assumed in the simulations, possibly in conjunction with a devaluation crisis on the part of the dollar. In the event of a rapid fall in the exchange rate on a rise in inflation, the Federal Reserve would in all likelihood shift to a restrictive policy. The combination of tax reform with no monetary offset (and conceivably even monetary restraint) would yield substantially worse economic outcomes than in any of the simulations presented here.

V. COMPARISON OF DEPRECIATION SYSTEMS

There are substantial methodological difficulties involved in undertaking a comparison of capital cost recovery systems across national boundaries. A full analysis would require an evaluation of the aggregate rental price of capital and nontax governmental incentives such as grants, subsidies and subsidized financing. The following estimates are drawn from a study by Arthur Andersen & Co. prepared for the Coalition for Growth, Jobs, and International Competitiveness. The methodology used is based on the present value of depreciation, deductions and credits although the overall rankings are effected by assumptions regarding anticipated inflation and other factors.

The tables given in Appendix III use the following approach. First, the value of allowed deductions and credits is quantified, and expressed as a percentage of the original acquisition cost of the plant. Then, because deductions are spread over a number of years (unless the country permits full expensing of capital assets), the valuation of deductions is adjusted for the rate of discount in order to determine their present value. By adjusting for the rate of time preference, or discount, it is therefore possible to assign values to cost recovery systems. The assigned values indicate the percentage of the asset's value that is fully recoverable, or stated another way, the first year deduction that would correspond to the deductions and credits actually permitted. In the tables, the discount rate is based on an anticipated inflation rate of 5 percent.

Other adjustments must be made for the acquisition date, discounting in the first year, and the expected rate of return. In the tables below, the asset is assumed to be acquired at the start of the year, and discounting is assumed to take place in the first year. The tables compare different rates of return on the asset.

Table 1, Appendix III compares the present value of cost recovery allowances for computer equipment in the United States, and fifteen other countries including the major industrial countries and three semi-industrial countries, Taiwan, Hong Kong and South Korea. Under current law (i.e. ACRS-ITC) the United States ranks fourth, while under H.R. 3838, it would rank eighth, irrespective of the rate of return. Table 2 makes the same comparison for the nominal value of cost recovery allowances over periods of one, three and five years. In the first year, the United States ranks sixth under current law and eighth under H.R. 3838. By the fifth year, however, the United States ranks third under current law, exceeded only by Luxembourg and Spain, while under H.R. 3838 the United States would rank eighth.

Table 3, Appendix III compares the present value of allowances for mining equipment. Under current law, the United States ranks fourth, whereas under H.R. 3838, the United States would rank last, irrespective of the rate of return. Table 4 makes the same comparison for the nominal value of cost recovery allowances. In the first year, the United States ranks eighth under current law and last under H.R. 3838. In the third year, the United States ranks seventh under current law and last under H.R. 3838. By the fifth year, the United States has moved up to third under current law, but is still ranked last under H.R. 3838.

Tables 5 and 6, Appendix III make the same comparison for manufacturing equipment. Ranked by present value, the United States ranks fifth under current law and fifteenth under H.R. 3838, irrespective of the rate of return. Ranked by the nominal value of deductions, the United States ranks sixth in years one and three, moving up to third by year five under current law, but last in every instance under H.R. 3838.

Finally, Tables 7 and 8, Appendix III effect the same comparisons for electric utility transmission equipment. Ranked by present value, the United States ranks ninth under current law, and fourteenth under H.R. 3838, irrespective of the rate of return. Ranked by the nominal value of deductions, the United States ranks eighth under current law and fourteenth under H.R. 3838 in the first year, with the ranks changing to ninth and fourteenth after the third.

In sum, the House tax reform bill would seriously worsen the competitive standing of American corporations vis-a-vis corporations in other countries from the standpoint of the tax deductions and credits applicable to new capital investment. Under current law, the United States enjoys one of the better capital cost recovery systems among the industrial countries, although it should be noted in this context that it is by no means the best, and not excessively generous by international standards. Under H.R. 3838, the United States would have one of the worst systems of all the industrial countries and several middle-income developing countries. This dramatic loss in access to deductions is fully commensurate with the prognosis given earlier that tax reform would significantly raise the user cost of capital and significantly reduce capital spending.

VI. THE TREATMENT OF DOMESTIC AND FOREIGN SOURCE INCOME

H.R. 3838 makes any number of changes in the treatment of foreign source income, which have significant implications for the competitive position of American firms with overseas affiliates.

In brief, H.R. 3838 would change the rules for the allocation of domestic and foreign source income by breaking up foreign source income into a series of categories based on type of income. Conversely, under current law, all foreign source income generally can be consolidated into a single aggregate, and the foreign tax credit is applicable against this aggregate. Under the new rules contained in H.R. 3838 each income category would require separate foreign tax credits. If they do not qualify for the respective foreign credits, they are liable for Federal taxes. Further, within each category, if foreign taxes are not paid, U.S. Federal income tax must be paid. These provisions are in total defiance of economic rationality. There is little theoretical basis for subdividing income by category as H.R. 3838 proposes. Instead, these apparently arbitrary subdivisions emerge as little more than a mechanism for raising additional revenue. In this respect, the changes in the treatment of foreign source income undermine the competitive position of American firms by raising their overall tax liabilities and by making overseas operations potentially subject to much higher rates of taxation than under current law.

Another adverse element of the proposed regulations is that American firms with foreign subsidiaries would be liable for Federal tax on foreign income before it is repatriated. Under current law, income from foreign subsidiaries is not recognized as domestic income until the affiliate actually pays it to the parent company (a provision known as deferral), although there are some exceptions under Subpart F. Under H.R. 3838, Subpart F exceptions would be

The House tax reform plan (H.R. 3838) would raise the user cost of capital by statistically significant magnitudes. The user cost would be raised primarily by the elimination of the Investment Tax Credit (ITC) and the replacement of the ACRS depreciation schedules with a longer cost recovery system. The increase in the user cost of capital is pervasive, and is corroborated by any number of independent econometric studies.

Second, the House plan would have a series of deleterious effects on the economy. Assuming that monetary policy is unchanged, the House plan would lead to: a) lower capital formation, due to the increase in the user cost; b) lower aggregate growth due to the contraction in investment spending; c) lower employment due to the growth slowdown; d) lower exports. Some of these adverse effects can be offset through a more expansionary monetary policy. In the event that the Federal Reserve reflates sufficiently, the output and employment losses can be avoided. Nevertheless, the economy will still undergo lower capital investment and a deterioration in the trade deficit, while the inflation rate will be raised.

Third, a comparison of depreciation systems across national boundaries indicates that while the United States currently has one of the better tax systems for cost recovery, it is not by any means excessively generous by international standards. Adoption of H.R. 3838 would give the United States one of the least favorable capital cost recovery systems of the industrial countries; in some instances, the United States would emerge with the single worst system of all the industrial countries and some middle-income developing countries.

Fourth, an analysis of the treatment of domestic and foreign source income under H.R. 3838 reveals the following effects. Income would be broken up into several separate income streams in order to raise effective tax rates by

greatly expanded. The result is that income from foreign subsidiaries would be treated as taxable income irrespective of whether or not it has been paid to the parent company. In addition to its revenue-raising implications, this provision would be uneconomical. In many instances, foreign ventures will not become viable until they are sufficiently capitalized; it may make more sense for profits to be reinvested abroad rather than repatriated. Further, this provision could place American corporations in a position of having to violate foreign law in order to pay domestic taxes; in the event that income would have to be repatriated to meet domestic tax obligations, corporations would run afoul of foreign laws which curtail remissions of profits.

Finally, one provision of H.R. 3838 that is potentially very dangerous for American corporations is a provision changing royalty procedures. The new rules would require that taxes be paid on royalties retroactively, i.e., if new technology is successful, it is taxable as though a higher royalty had been paid when the foreign corporation obtained a license to use it, even if in fact a lower royalty was paid. This would place American firms in the position of having to try to determine in advance the ultimate value of a given technology before issuing licenses for it. In the event of a failure to correctly gauge this, American firms would find themselves in the position of having to pay taxes on royalties that they did not earn.

VII. CONCLUSIONS

NAM opposes changes in the tax law which would undermine the competitive position of American corporations by increasing the effective rate of taxation on capital investment.

denying corporations their historic access to foreign tax credits. Corporations would be taxable on the income of foreign subsidiaries even before this income is repatriated.

Overall, the House tax plan would seriously undermine the competitive position of American corporations, in addition to producing substantially more adverse economic outcomes in the aggregate.

For all of the foregoing reasons, we believe H.R. 3838 is irreparably flawed and should be dropped entirely as a vehicle for tax reform. We urge this Committee to communicate such a recommendation to its colleagues on the Senate Finance Committee.

American manufacturers are prepared to support a reform bill that achieves the desirable goals of marginal rate reduction and real simplification, and does so in a fashion that enhances, rather than detracts from, economic growth and international competitiveness. Such a reform bill, however, must strike a fair balance between the taxation of individuals and the taxation of corporations, and also much achieve greater neutrality as between the taxation of income and the taxation of consumption. H.R. 3838 simply is not such a bill.

In sum, we believe the Senate should abandon H.R. 3838 and instead should devise its own tax reform plan.

Table 1

CHANGES IN THE COST OF U.S. CORPORATE NONRESIDENTIAL FIXED CAPITAL BY ASSET IN MOVING FROM PRESENT LAW TO H.R. 3838 (WITHOUT DIVIDEND DEDUCTION)

prepared for
THE NATIONAL ASSOCIATION OF MANUFACTURERS

Aggregate Asset Classes	Percent Change in Cost of Capital
Equipment	12.3 %
Furniture and Fabricated Metal Products	15.6
Machinery and Equipment	12.2
Office and Computing Machinery	9.0
Other	14.0
Transportation Equipment	10.7
Autos and Trucks	8.5
Other	19.4
Other Equipment	13.7
Structures	3.1
Buildings	-0.1
Other Structures	9.8
Mining	0.1
Transportation and Public Utilities	12.4
Other	23.3
Nonresidential Fixed Investment	9.2 %

Fiscal Associates, Inc.
December 12, 1985

Table 2

CHANGES IN THE COST OF U.S. CORPORATE NONRESIDENTIAL FIXED CAPITAL BY ASSET IN MOVING FROM PRESENT LAW TO H.R. 3838 (WITH DIVIDEND DEDUCTION)
prepared for
THE NATIONAL ASSOCIATION OF MANUFACTURERS

Aggregate Asset Classes	Percent Change in Cost of Capital
Equipment	8.3 %
Furniture and Fabricated Metal Products	11.6
Machinery and Equipment	8.2
Office and Computing Machinery	5.1
Other	10.0
Transportation Equipment	6.8
Autos and Trucks	4.7
Other	15.2
Other Equipment	9.7
Structures	-0.4
Buildings	-3.5
Other Structures	6.0
Mining	-3.4
Transportation and Public Utilities	8.5
Other	19.0
Nonresidential Fixed Investment	5.4 %

Fiscal Associates, Inc.
December 12, 1985

APPENDIX I

Table 3

CHANGE IN THE COST OF U.S. CORPORATE NONRESIDENTIAL FIXED CAPITAL
BY INDUSTRY IN MOVING FROM PRESENT LAW TO H.R. 3838 (WITHOUT DIVIDEND DEDUCTION)
(in percent)
prepared for
THE NATIONAL ASSOCIATION OF MANUFACTURERS

Industry Groups	Equipment	Buildings	Other Structures	Total Structures	Nonresidential Fixed Investment
Agriculture	15.3 %	-0.0 %	17.2 %	16.1 %	15.5 %
Mining	14.8	-0.1	0.7	0.6	6.5
Construction	9.1	-0.1	28.7	-0.0	6.5
Manufacturing	15.9	-0.1	28.7	0.0	10.8
Nondurable Manufacturing	16.8	-0.1	28.7	0.1	11.0
Food, Beverages, and Tobacco Products	18.9	-0.1	28.7	-0.1	11.9
Textile Products and Apparel	13.9	-0.1	28.7	-0.1	8.7
Paper and Paperboard	19.3	-0.1	28.7	0.1	15.4
Printing and Publishing	13.6	-0.1	28.7	-0.1	8.7
Chemicals and Allied Products	14.2	-0.1	28.7	0.0	10.0
Petroleum Refining	22.9	-0.1	28.7	0.3	10.2
Leather and Footwear	15.3	-0.1	NA	-0.1	8.9
Durable Maufacturing	15.3	-0.1	28.7	-0.0	10.7
Lumber, Wood Products, and Furniture	11.5	-0.1	28.7	0.2	8.0
Glass and Stone Products	17.8	-0.1	28.7	-0.1	12.7
Primary Metals	19.8	-0.1	28.7	-0.1	12.4
Fabricated Metal Products	14.9	-0.1	28.7	-0.1	10.2
Machinery and Equipment	13.3	-0.1	28.7	-0.1	9.8
Transportation Equipment	15.9	-0.1	28.7	0.3	11.4
Instruments	14.9	-0.1	28.7	-0.1	10.1
Other Manufacturing	14.5	-0.1	NA	-0.1	9.0
Transportation and Public Utilities	11.1	-0.1	12.4	11.6	11.3
Transportation	15.9	-0.1	33.2	25.1	17.1
Communications	9.3	-0.1	12.4	11.6	9.9
Public Utilities	9.2	-0.1	10.1	9.6	9.4
Wholesale and Retail Trade	10.7	-0.0	28.7	-0.0	7.3
Finance, Insurance, and Real Estate	9.9	-0.1	28.7	1.6	7.6
Services	10.6	-0.1	28.7	0.0	7.1
All Industries	12.3 %	-0.1 %	9.8 %	3.1 %	9.2 %

Fiscal Associates, Inc.
December 12, 1985

APPENDIX I

Table 4

CHANGE IN THE COST OF U.S. CORPORATE NONRESIDENTIAL FIXED CAPITAL
BY INDUSTRY IN MOVING FROM PRESENT LAW TO H.R. 3838 (WITH DIVIDEND DEDUCTION)
(in percent)
prepared for
THE NATIONAL ASSOCIATION OF MANUFACTURERS

Industry Groups	Equipment	Buildings	Other Structures	Total Structures	Nonresidential Fixed Investment
Agriculture	11.2 %	-3.4 %	13.2 %	12.1 %	11.5 %
Mining	10.7	-3.5	-2.8	-3.0	2.8
Construction	5.2	-3.5	24.2	-3.4	2.7
Manufacturing	11.8	-3.5	24.2	-3.4	6.9
Nondurable Manufacturing	12.6	-3.5	24.2	-3.4	7.1
Food, Beverages, and Tobacco Products	14.8	-3.5	24.2	-3.5	8.0
Textile Products and Apparel	9.9	-3.5	24.2	-3.5	4.9
Paper and Paperboard	15.2	-3.5	24.2	-3.3	11.4
Printing and Publishing	9.6	-3.5	24.2	-3.5	4.9
Chemicals and Allied Products	10.2	-3.5	24.2	-3.4	6.2
Petroleum Refining	18.6	-3.5	24.2	-3.1	6.4
Leather and Footwear	11.2	-3.5	NA	-3.5	5.1
Durable Maufacturing	11.2	-3.5	24.2	-3.4	6.8
Lumber, Wood Products, and Furniture	7.5	-3.5	24.2	-3.2	4.2
Glass and Stone Products	13.7	-3.5	24.2	-3.5	8.8
Primary Metals	15.5	-3.5	24.2	-3.5	8.5
Fabricated Metal Products	10.9	-3.5	24.2	-3.5	6.3
Machinery and Equipment	9.3	-3.5	24.2	-3.5	5.9
Transportation Equipment	11.8	-3.5	24.2	-3.1	7.5
Instruments	10.9	-3.5	24.2	-3.5	6.2
Other Manufacturing	10.4	-3.5	NA	-3.5	5.2
Transportation and Public Utilities	7.2	-3.5	8.5	7.7	7.4
Transportation	11.8	-3.5	28.6	20.7	13.0
Communications	5.5	-3.5	8.6	7.8	6.0
Public Utilities	5.4	-3.5	6.3	5.8	5.6
Wholesale and Retail Trade	6.8	-3.4	24.2	-3.4	3.5
Finance, Insurance, and Real Estate	6.0	-3.5	24.2	-1.9	3.8
Services	6.7	-3.5	24.2	-3.4	3.4
All Industries	8.3 %	-3.5 %	6.0 %	-0.4 %	5.4 %

Fiscal Associates, Inc.
December 12, 1985

Table 5

Corporate Cost of Capital Under Current Law and Application of Successive Provisions of H.R. 3838
(In Percent)
prepared for
THE NATIONAL ASSOCIATION OF MANUFACTURERS

Asset Aggregates	Current Law	Removal of the ITC	Plus Replace ACRS Depreciation	Plus Corporate Rate Reduction	Plus Personal Rate Reduction	Plus Dividend Deduction
Equipment	29.0 %	33.7 %	34.5 %	33.0 %	32.6 %	31.6 %
Furniture and Fabricated Metal Products	23.1	26.9	28.8	27.1	26.7	25.7
Machinery and Equipment	27.4	32.0	32.6	31.2	30.7	29.6
Office and Computing Machinery	42.0	49.0	47.8	46.6	45.7	44.1
Other	22.9	26.7	27.9	26.4	26.1	25.2
Transportation Equipment	42.7	48.5	49.7	47.9	47.3	45.6
Autos and Trucks	57.3	64.7	65.2	63.2	62.4	60.1
Other	21.1	24.6	27.1	25.5	25.1	24.3
Other Equipment	25.5	29.8	30.9	29.4	29.0	28.0
Structures	12.7	13.2	14.7	13.3	13.1	12.7
Buildings	11.8	11.8	13.3	11.9	11.8	11.4
Other Structures	15.4	17.0	18.4	17.1	16.9	16.3
Mining	22.6	22.6	23.0	22.9	22.6	21.8
Transportation and Public Utilities	13.8	15.8	17.2	15.7	15.5	14.9
Other	13.9	16.2	18.7	17.4	17.1	16.5
Nonresidential Fixed Investment	20.3 %	22.7 %	23.9 %	22.5 %	22.2 %	21.4 %

Fiscal Associates, Inc.
December 12, 1985

Table 6

Incremental Changes in Corporate Cost of Capital
Due to Selected Provisions of H.R. 3838
prepared for
THE NATIONAL ASSOCIATION OF MANUFACTURERS

Asset Aggregates	Removal of the ITC	Replace ACRS Depreciation	Corporate Rate Reduction	Personal Rate Reduction	Dividend Deduction
Equipment	16.0 %	2.6 %	-4.6 %	-1.4 %	-3.5 %
Furniture and Fabricated Metal Products	16.5	7.0	-5.9	-1.4	-3.5
Machinery and Equipment	16.7	1.9	-4.3	-1.4	-3.5
Office and Computing Machinery	16.9	-2.6	-3.0	-1.4	-3.6
Other	16.6	4.4	-5.1	-1.4	-3.5
Transportation Equipment	13.5	2.7	-3.6	-1.4	-3.6
Autos and Trucks	12.6	0.7	-3.0	-1.4	-3.6
Other	16.9	10.1	-5.9	-1.4	-3.5
Other Equipment	16.6	4.0	-4.9	-1.4	-3.5
Structures	3.5	11.4	-9.6	-1.3	-3.4
Buildings	0.0	13.3	-10.6	-1.3	-3.4
Other Structures	10.9	7.8	-6.9	-1.4	-3.5
Mining	0.0	1.8	-0.3	-1.4	-3.5
Transportation and Public Utilities	14.6	9.2	-9.0	-1.4	-3.5
Other	16.8	15.0	-7.0	-1.4	-3.5
Nonresidential Fixed Investment	11.8 %	5.3 %	-6.0 %	-1.4 %	-3.5 %

Table 7

Cumulative Changes in Corporate Cost of Capital
Due to Selected Provisions of H.R. 3838
Measured Relative to Current Law
prepared for
THE NATIONAL ASSOCIATION OF MANUFACTURERS

Asset Aggregates	Removal of the ITC	Plus Replace ACRS Depreciation	Plus Corporate Rate Reduction	Plus Personal Rate Reduction	Plus Dividend Deduction
Equipment	16.0 %	19.0 %	13.8 %	12.3 %	8.3 %
Furniture and Fabricated Metal Products	16.5	24.6	17.2	15.6	11.6
Machinery and Equipment	16.7	18.9	13.7	12.2	8.2
Office and Computing Machinery	16.9	13.9	10.5	9.0	5.1
Other	16.6	21.8	15.6	14.0	10.0
Transportation Equipment	13.5	16.5	12.3	10.7	6.8
Autos and Trucks	12.6	13.5	10.1	8.5	4.7
Other	16.9	28.7	21.0	19.4	15.2
Other Equipment	16.6	21.3	15.3	13.7	9.7
Structures	3.5	15.3	4.5	3.1	-0.4
Buildings	0.0	13.3	1.3	-0.1	-3.5
Other Structures	10.9	19.4	11.3	9.8	6.0
Mining	0.0	1.8	1.5	0.1	-3.4
Transportation and Public Utilities	14.6	25.2	16.0	12.6	8.5
Other	16.8	34.3	25.0	23.2	19.0
Nonresidential Fixed Investment	11.8 %	17.8 %	10.7 %	9.2 %	5.6 %

Fiscal Associates, Inc.
December 12, 1985

Table 8

CHANGES IN THE COST OF U.S. NONCORPORATE NONRESIDENTIAL
FIXED CAPITAL BY ASSET IN MOVING FROM PRESENT LAW
TO H.R. 3838
prepared for
THE NATIONAL ASSOCIATION OF MANUFACTURERS

Aggregate Asset Classes	Percent Change in Cost of Capital
Equipment	14.0 %
Furniture and Fabricated Metal Products	16.8
Machinery and Equipment	14.3
Office and Computing Machinery	11.9
Other	15.6
Transportation Equipment	12.2
Autos and Trucks	10.6
Other	19.2
Other Equipment	15.1
Structures	10.3
Buildings	6.6
Other Structures	14.2
Mining	0.9
Transportation and Public Utilities	17.9
Other	18.2
Nonresidential Fixed Investment	12.3 %

Fiscal Associates, Inc.
December 12, 1985

Table 9

CHANGE IN THE COST OF U.S. NONCORPORATE NONRESIDENTIAL FIXED CAPITAL
BY INDUSTRY IN MOVING FROM PRESENT LAW TO H.R. 3838
(in percent)
prepared for
THE NATIONAL ASSOCIATION OF MANUFACTURERS

Industry Groups	Equipment	Buildings	Other Structures	Total Structures	Nonresidential Fixed Investment
Agriculture	16.2 %	6.7 %	17.5 %	16.8 %	16.4 %
Mining	15.8	6.7	1.4	2.4	6.0
Construction	11.9	6.7	25.5	6.7	9.7
Manufacturing	16.2	6.7	25.5	6.7	12.3
Nondurable Manufacturing	16.8	6.7	25.5	6.7	13.1
Food, Beverages, and Tobacco Products	18.5	6.7	25.5	6.7	13.7
Textile Products and Apparel	14.9	6.7	25.5	6.7	10.6
Paper and Paperboard	19.4	6.7	25.5	6.7	14.5
Printing and Publishing	15.3	6.7	25.5	6.7	9.5
Chemicals and Allied Products	14.7	6.7	25.5	6.7	13.2
Petroleum Refining	21.2	6.7	25.5	7.1	16.4
Leather and Footwear	16.2	6.7	NA	6.7	10.2
Durable Maufacturing	14.9	6.7	25.5	6.7	10.8
Lumber, Wood Products, and Furniture	13.1	6.7	25.5	6.8	9.8
Glass and Stone Products	18.3	6.7	25.5	6.7	12.6
Primary Metals	19.6	6.7	25.5	6.7	12.0
Fabricated Metal Products	16.3	6.7	25.5	6.7	10.2
Machinery and Equipment	15.0	6.7	25.5	6.7	11.6
Transportation Equipment	16.6	6.7	25.5	6.8	12.0
Instruments	16.0	6.7	25.5	6.7	12.5
Other Manufacturing	16.1	6.7	NA	6.7	10.7
Transportation and Public Utilities	14.3	6.7	17.9	17.1	15.7
Transportation	16.5	6.7	28.7	23.3	18.1
Communications	12.1	6.7	18.4	17.6	14.2
Public Utilities	15.0	6.7	16.5	16.0	15.7
Wholesale and Retail Trade	12.6	6.7	25.5	6.7	9.9
Finance, Insurance, and Real Estate	12.2	6.7	25.5	7.8	10.3
Services	12.9	6.6	25.5	6.7	9.9
All Industries	14.0 %	6.6 %	14.2 %	10.3 %	12.3 %

Fiscal Associates, Inc.
December 12, 1985

Table A.1

ASSUMPTIONS USED IN CALCULATING CORPORATE COST OF CAPITAL UNDER PRESENT LAW AND H.R. 3838

Parameters	Present Law	H.R. 3838
Discount Rate for After Tax Real Flows	3.50 %	3.50 %
Adjusted for Property Tax	3.77 %	3.83 %
Federal Tax Rates		
Corporate Tax Rate	46.00 %	36.00 %
Dividend Tax Rate	30.00 %	29.00 %
State and Local Tax Rates		
Property Tax Rate	0.80 %	0.80 %
Sales Tax Rate	5.30 %	5.30 %
Corporate Tax Rate	10.40 %	10.40 %
Dividend Tax Rate	5.10 %	5.10 %
Dividend Deduction Rate	0.00 %	10.00 %
Total Dividend Tax Rate[1]	33.57 %	30.10 %
Total Corporate Tax Rate	51.62 %	42.66 %
Investment Tax Credit Parameters		
Effective Rate ("Regular Percentage")	10.00 %	0.00 %
Basis Adjustment Factor	50.00 %	0.00 %
Depreciation Provisions		
Write-off Method	ACRS[2]	IDS[3]
Indexation	None	Partial[4]
Inflation Premium for Nominal Discount Rate		
Inflation Forecast	3.00 %	3.00 %
Risk Premium	0.50 %	0.50 %

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[1] Adjusted for dividend deduction rate. The total dividend tax rate is 32.66 percent under H.R. 3838 without the dividend deduction provision.

[2] Accelerated Cost Recovery System.

[3] Incentive Depreciation System.

[4] Fifty percent of excess annual inflation over 5 percent.

Fiscal Associates, Inc.
December 12, 1985

Table A.2

ASSUMPTIONS USED IN CALCULATING NONCORPORATE COST OF CAPITAL UNDER PRESENT LAW AND H.R. 3838

Parameters	Present Law	H.R. 3838
Discount Rate for After Tax Real Flows	3.50 %	3.50 %
Adjusted for Property Tax	4.05 %	4.06 %
Federal Tax Rates		
Personal Tax Rate	30.00 %	29.00 %
State and Local Tax Rates		
Property Tax Rate	0.80 %	0.80 %
Sales Tax Rate	5.30 %	5.30 %
Personal Tax Rate	5.10 %	5.10 %
Total Personal Tax Rate	33.57 %	32.62 %
Investment Tax Credit Parameters		
Effective Rate ("Regular Percentage")	10.00 %	0.00 %
Basis Adjustment Factor	50.00 %	0.00 %
Depreciation Provisions		
Write-off Method	ACRS[1]	IDS[2]
Indexation	None	Partial[3]
Inflation Premium for Nominal Discount Rate		
Inflation Forecast	3.00 %	3.00 %
Risk Premium	0.50 %	0.50 %

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[1] Accelerated Cost Recovery System.

[2] Incentive Depreciation System.

[3] Fifty percent of excess annual inflation over 5 percent.

Fiscal Associates, Inc.
December 12, 1985

TAX REFORM SIM #1: "CBO BASELINE"

APPENDIX II

Summary Economic Measures
(% chg annual rate, unless noted*)

	Q4 TO Q4 % CH								
	1983	1984	1985	1986	1987	1988	1989	1990	1991
Real GNP, total............	6.3	5.7	2.0	3.1	3.3	3.1	3.2	3.3	3.1
Consumption..............	5.7	4.2	3.6	2.7	2.7	2.6	2.9	3.4	3.4
Fixed Investment.........	19.7	12.8	2.4	5.1	3.6	3.5	3.5	4.1	3.1
Producer Durables......	21.3	16.0	2.9	6.6	2.4	5.5	4.8	6.0	5.3
Nonres Structures......	-1.0	15.6	2.3	1.6	4.1	3.3	3.1	1.2	-.9
Residential............	41.7	2.4	1.1	4.7	6.3	-1.4	.0	1.5	.5
Govt Purchases...........	-3.9	7.5	5.4	1.8	3.1	3.3	3.4	3.4	3.2
Exports..................	3.1	4.3	-5.4	2.6	2.4	3.0	3.7	4.1	4.0
Imports..................	23.5	15.4	7.4	2.7	2.2	3.1	4.0	4.3	4.6
GNP Deflator...............	3.8	3.6	3.8	3.9	4.0	3.9	3.8	3.9	4.1
Civ Unemployment Rate (%)..	8.5	7.2	6.9	6.9	6.8	6.8	6.3	6.0	5.4
Corp Profits After Tax.....	40.0	-.1	14.4	1.2	3.3	3.7	.5	-2.4	-3.6
Federal Deficit (bil,NIPA).	-180.5	-197.8	-198.6	-211.4	-234.8	-255.7	-252.1	-275.2	-308.4
Personal Saving Rate.(%)...	5.3	6.2	3.7	4.0	4.9	5.2	5.8	6.3	6.7
Money Stock (M1)...........	10.5	5.8	10.8	6.0	6.0	6.0	6.0	6.0	6.0
Nonborrowed Reserves.......	5.6	6.6	13.0	5.6	6.0	5.9	5.9	5.5	5.5
Treasury Bill Rate (%).....	8.8	8.8	7.4	7.4	7.3	7.1	7.0	7.0	7.0
Corp Bond Rate (%).........	12.4	12.4	10.8	9.8	9.2	9.1	9.0	9.0	8.9
Real Corp Bond Rate (%)....	4.9	5.4	4.7	4.7	5.0	5.3	5.2	5.1	5.0
Rental Prices of Investment									
Consumer Durables (%)....	22.4	22.6	21.8	21.3	20.9	20.3	19.8	19.3	18.8
Single Family Starts (%).	17.5	16.0	15.2	14.4	13.3	13.4	13.5	13.6	13.6
Multi Family Starts (%)..	20.0	18.6	17.6	16.5	15.2	15.3	15.5	15.6	15.7
Producer Durables (%)....	19.4	19.0	18.5	18.6	18.8	18.8	18.5	18.1	17.8
Nonres Strucutres (%)....	18.0	18.4	18.0	18.6	19.6	20.4	20.6	20.6	20.8
Business Inventories (%).	9.5	11.0	8.3	7.0	6.9	6.5	6.3	6.2	6.0
Real Capital Stocks (bil $72)									
Consumer Durables........	612.3	648.8	690.7	727.1	761.5	793.2	826.5	862.2	900.0
Residential..............	1180.2	1211.8	1241.7	1269.7	1302.0	1334.3	1365.5	1396.9	1428.2
Producer Durables........	680.0	724.2	770.1	817.9	865.4	913.1	963.6	1015.9	1071.4
Nonres Structures........	663.4	682.7	705.2	726.4	748.6	771.9	795.9	820.0	842.4
Business Inventories.....	336.5	361.3	369.8	382.1	399.3	422.5	450.4	478.6	504.5

* Levels are for 4th qtr of year

Source: Laurence H. Meyer & Assoc

TAX REFORM SIM #2: NONACCOMMODATED & NO DARBY EFFECT

APPENDIX II

Summary Economic Measures
(% chg annual rate, unless noted*)

	Q4 TO Q4 % CH								
	1983	1984	1985	1986	1987	1988	1989	1990	1991
Real GNP, total............	6.3	5.7	2.0	3.0	3.0	2.5	2.5	2.6	2.6
Consumption..............	5.7	4.2	3.6	3.2	2.9	2.4	2.5	2.8	2.8
Fixed Investment.........	19.7	12.8	2.3	2.2	1.1	.3	.3	1.6	1.2
Producer Durables......	21.3	16.0	2.9	2.8	-2.4	.5	.6	3.3	3.6
Nonres Structures......	-1.0	15.6	2.2	.5	2.5	1.0	.4	-1.6	-3.5
Residential............	41.7	2.4	1.1	2.3	8.9	-.9	-.7	.5	-.4
Govt Purchases...........	-3.9	7.5	5.4	1.8	3.1	3.4	3.5	3.5	3.6
Exports..................	3.1	4.3	-5.4	2.5	2.0	2.4	2.7	3.0	3.0
Imports..................	23.5	15.4	7.4	2.3	1.8	1.7	2.1	2.2	2.5
GNP Deflator...............	3.8	3.6	3.8	4.0	4.1	4.0	4.0	4.0	3.9
Civ Unemployment Rate (%)..	8.5	7.2	6.9	6.9	7.0	7.2	7.1	7.0	6.7
Corp Profits After Tax.....	40.0	-.1	14.3	-.2	10.2	2.7	.1	-.9	.1
Federal Deficit (bil,NIPA).	-180.5	-197.8	-198.8	-226.6	-245.7	-250.9	-272.7	-299.0	-333.6
Personal Saving Rate.(%)...	5.3	6.2	3.7	4.8	5.3	5.5	6.1	6.5	6.9
Money Stock (M1)...........	10.5	5.8	10.8	6.1	6.0	6.0	5.9	5.8	5.8
Nonborrowed Reserves.......	5.6	6.6	12.9	5.6	6.0	6.1	5.9	5.4	5.7
Treasury Bill Rate (%).....	8.8	8.8	7.5	7.4	7.3	7.0	6.8	6.7	6.6
Corp Bond Rate (%).........	12.4	12.4	10.8	9.8	9.2	9.0	8.9	8.8	8.6
Real Corp Bond Rate (%)....	4.9	5.4	4.7	4.7	4.9	5.2	5.1	4.9	4.7
Rental Prices of Investment									
Consumer Durables (%)....	22.4	22.6	21.8	21.6	21.1	20.5	20.0	19.4	18.9
Single Family Starts (%).	17.5	16.0	15.2	15.0	13.9	13.9	14.0	14.0	13.9
Multi Family Starts (%)..	20.0	18.6	17.6	17.7	16.3	16.4	16.5	16.6	16.5
Producer Durables (%)....	19.4	19.0	18.5	22.0	22.2	22.1	21.8	21.3	20.9
Nonres Strucutres (%)....	18.0	18.4	18.0	20.7	21.7	22.4	22.5	22.4	22.4
Business Inventories (%).	9.5	11.0	8.3	7.1	6.9	6.4	6.1	5.9	5.7
Real Capital Stocks (bil $72)									
Consumer Durables........	612.3	648.8	690.7	727.7	764.0	796.2	827.9	860.0	892.4
Residential..............	1180.2	1211.8	1241.7	1268.9	1300.8	1333.4	1364.9	1395.7	1425.9
Producer Durables........	680.0	724.2	770.1	814.4	852.0	883.2	911.6	938.4	967.0
Nonres Structures........	663.4	682.7	705.2	726.0	746.9	767.8	787.8	806.3	821.8
Business Inventories.....	336.5	361.3	369.7	381.8	398.5	420.4	445.8	470.4	492.3

* Levels are for 4th qtr of year

TAX REFORM SIM #3: NONACCOMMODATED WITH DARBY EFFECT

APPENDIX II

Summary Economic Measures
(% chg annual rate, unless noted*)

	Q4 TO Q4 % CH								
	1983	1984	1985	1986	1987	1988	1989	1990	1991
Real GNP, total............	6.3	5.7	2.0	3.6	3.6	2.9	2.7	2.8	2.7
Consumption..............	5.7	4.2	3.6	3.5	3.4	2.8	2.8	3.2	3.2
Fixed Investment.........	19.7	12.8	2.3	3.6	3.1	1.9	1.3	2.0	1.3
Producer Durables......	21.3	16.0	2.9	3.9	-.5	2.3	1.8	3.7	3.6
Nonres Structures......	-1.0	15.6	2.2	1.3	3.9	2.6	1.8	-.4	-2.6
Residential............	41.7	2.4	1.1	5.0	11.8	.4	-.6	-.1	-1.0
Govt Purchases...........	-3.9	7.5	5.4	1.7	3.0	3.2	3.2	3.2	3.1
Exports..................	3.1	4.3	-5.4	2.7	2.5	2.9	3.2	3.2	3.0
Imports..................	23.5	15.4	7.4	2.4	3.3	3.1	3.3	3.2	3.5
GNP Deflator...............	3.8	3.6	3.8	4.0	4.3	4.2	4.2	4.2	4.2
Civ Unemployment Rate (%)..	8.5	7.2	6.9	6.7	6.6	6.6	6.3	6.1	5.7
Corp Profits After Tax.....	40.0	-.1	14.3	6.1	15.1	5.3	1.2	-.9	-.4
Federal Deficit (bil,NIPA).	-180.5	-197.8	-198.8	-216.5	-222.7	-216.2	-227.7	-244.9	-270.3
Personal Saving Rate.(%)...	5.3	6.2	3.7	4.5	4.7	4.6	4.9	5.0	5.1
Money Stock (M1)...........	10.5	5.8	10.8	5.4	6.3	6.1	6.0	6.0	6.0
Nonborrowed Reserves.......	5.6	6.6	12.9	5.6	6.0	6.1	5.9	5.4	5.7
Treasury Bill Rate (%).....	8.8	8.8	7.5	6.7	6.6	6.4	6.2	6.2	6.2
Corp Bond Rate (%).........	12.4	12.4	10.8	9.4	8.6	8.4	8.3	8.3	8.2
Real Corp Bond Rate (%)....	4.9	5.4	4.7	4.3	4.4	4.5	4.4	4.2	4.1
Rental Prices of Investment									
Consumer Durables (%)....	22.4	22.6	21.8	21.4	20.7	20.1	19.6	19.0	18.5
Single Family Starts (%).	17.5	16.0	15.2	14.6	13.2	13.1	13.3	13.4	13.4
Multi Family Starts (%)..	20.0	18.6	17.6	17.2	15.5	15.4	15.6	15.8	15.8
Producer Durables (%)....	19.4	19.0	18.5	21.6	21.6	21.4	21.0	20.6	20.2
Nonres Strucutres (%)....	18.0	18.4	18.0	20.2	20.8	21.3	21.4	21.5	21.5
Business Inventories (%).	9.5	11.0	8.3	6.1	6.1	5.7	5.4	5.3	5.1
Real Capital Stocks (bil $72)									
Consumer Durables........	612.3	648.8	690.7	729.2	768.9	805.4	841.7	878.0	914.5
Residential..............	1180.2	1211.8	1241.7	1269.7	1304.4	1341.1	1376.8	1411.6	1445.2
Producer Durables........	680.0	724.2	770.1	815.3	856.3	893.2	928.9	963.4	999.2
Nonres Structures........	663.4	682.7	705.2	726.3	748.2	771.0	793.8	815.8	835.1
Business Inventories.....	336.5	361.3	369.7	382.7	402.2	426.9	455.0	481.9	505.5

* Levels are for 4th qtr of year

TAX REFORM SIM #4: PARTLY ACCOMMODATED WITH DARBY EFFECT

APPENDIX II

Summary Economic Measures
(% chg annual rate, unless noted*)

	Q4 TO Q4 % CH								
	1983	1984	1985	1986	1987	1988	1989	1990	1991
Real GNP, total............	6.3	5.7	2.0	3.9	3.6	2.8	2.6	2.7	2.7
Consumption..............	5.7	4.2	3.6	3.8	3.5	2.8	2.8	3.1	3.2
Fixed Investment.........	19.7	12.8	2.4	4.6	3.3	1.7	.7	1.5	1.1
Producer Durables......	21.3	16.0	2.9	4.8	-.2	2.2	1.3	3.2	3.4
Nonres Structures......	-1.0	15.6	2.3	1.9	4.2	2.6	1.7	-.7	-2.9
Residential............	41.7	2.4	1.1	6.9	11.5	-.5	-1.5	-.5	-.9
Govt Purchases...........	-3.9	7.5	5.4	1.7	2.9	3.1	3.2	3.2	3.2
Exports..................	3.1	4.3	-5.4	2.8	2.7	3.0	3.1	3.0	2.9
Imports..................	23.5	15.4	7.4	2.9	3.7	3.1	3.0	2.9	3.3
GNP Deflator...............	3.8	3.6	3.8	4.0	4.3	4.2	4.2	4.2	4.2
Civ Unemployment Rate (%)..	8.5	7.2	6.9	6.6	6.5	6.5	6.2	6.1	5.7
Corp Profits After Tax.....	40.0	-.1	14.4	10.0	14.0	3.9	-.2	-1.7	-.4
Federal Deficit (bil,NIPA).	-180.5	-197.8	-198.6	-209.7	-215.5	-210.4	-224.2	-243.1	-269.0
Personal Saving Rate.(%)...	5.3	6.2	3.7	4.3	4.5	4.4	4.7	4.9	5.0
Money Stock (M1)...........	10.5	5.8	10.8	6.0	6.0	6.0	6.0	6.0	6.0
Nonborrowed Reserves.......	5.6	6.6	13.0	6.2	5.6	5.8	5.9	5.5	5.6
Treasury Bill Rate (%).....	8.8	8.8	7.4	6.6	6.6	6.5	6.3	6.3	6.2
Corp Bond Rate (%).........	12.4	12.4	10.8	9.3	8.5	8.3	8.3	8.3	8.2
Real Corp Bond Rate (%)....	4.9	5.4	4.7	4.1	4.2	4.4	4.4	4.3	4.1
Rental Prices of Investment									
Consumer Durables (%)....	22.4	22.6	21.8	21.3	20.6	20.0	19.6	19.0	18.5
Single Family Starts (%).	17.5	16.0	15.2	14.5	13.1	13.1	13.3	13.5	13.5
Multi Family Starts (%)..	20.0	18.6	17.6	17.0	15.3	15.3	15.6	15.9	16.0
Producer Durables (%)....	19.4	19.0	18.5	21.5	21.4	21.3	21.0	20.6	20.2
Nonres Strucutres (%)....	18.0	18.4	18.0	19.9	20.6	21.3	21.5	21.5	21.5
Business Inventories (%).	9.5	11.0	8.3	6.0	6.1	5.8	5.5	5.3	5.1
Real Capital Stocks (bil $72)									
Consumer Durables........	612.3	648.8	690.7	730.4	771.1	808.2	844.2	880.0	916.0
Residential..............	1180.2	1211.8	1241.7	1270.5	1306.3	1343.7	1379.4	1413.7	1446.9
Producer Durables........	680.0	724.2	770.1	816.1	858.6	896.9	933.2	967.4	1002.3
Nonres Structures........	663.4	682.7	705.2	726.5	749.0	772.4	795.7	818.0	837.4
Business Inventories.....	336.5	361.3	369.8	383.7	403.8	428.7	456.4	482.8	506.0

* Levels are for 4th qtr of year

Source: Laurence H. Meyer & Assoc

APPENDIX II

TAX REFORM SIM #5: ACCOMMODATED WITH DARBY EFFECT

Summary Economic Measures
(% chg annual rate, unless noted*)

				Q4 TO Q4 % CH					
	1983	1984	1985	1986	1987	1988	1989	1990	1991
Real GNP, total............	6.3	5.7	2.0	3.1	3.4	3.2	3.2	3.3	3.2
Consumption..............	5.7	4.2	3.6	3.2	3.2	2.9	3.1	3.6	3.7
Fixed Investment.........	19.7	12.8	2.4	2.5	2.1	2.3	2.8	4.1	3.4
Producer Durables......	21.3	16.0	2.9	3.1	-1.5	2.4	3.1	5.9	5.8
Nonres Structures......	-1.0	15.6	2.3	.7	3.1	2.4	2.4	.9	-.7
Residential............	41.7	2.4	1.1	3.0	10.5	2.0	2.3	2.8	.9
Govt Purchases...........	-3.9	7.5	5.4	1.8	3.1	3.2	3.2	3.1	2.9
Exports..................	3.1	4.3	-5.4	2.5	2.2	2.8	3.4	3.7	3.6
Imports..................	23.5	15.4	7.4	2.4	2.2	2.6	3.9	4.5	5.2
GNP Deflator...............	3.8	3.6	3.8	4.0	4.2	4.1	4.1	4.3	4.5
Civ Unemployment Rate (%)..	8.5	7.2	6.9	6.9	6.8	6.8	6.3	5.9	5.3
Corp Profits After Tax.....	40.0	-.1	14.4	1.4	13.8	9.0	5.8	4.2	3.8
Federal Deficit (bil,NIPA).	-180.5	-197.8	-198.6	-224.0	-235.8	-224.9	-226.7	-229.6	-238.7
Personal Saving Rate.(%)...	5.3	6.2	3.7	4.7	5.1	4.9	5.0	4.9	4.7
Money Stock (M1)...........	10.5	5.8	10.8	4.5	6.5	6.9	6.5	6.5	6.5
Nonborrowed Reserves.......	5.6	6.6	13.0	3.6	7.0	7.7	6.6	6.1	6.1
Treasury Bill Rate (%).....	8.8	8.8	7.4	7.2	6.8	6.1	5.8	5.7	5.6
Corp Bond Rate (%).........	12.4	12.4	10.8	9.7	8.9	8.4	8.1	7.8	7.6
Real Corp Bond Rate (%)....	4.9	5.4	4.7	4.6	4.6	4.5	4.2	3.8	3.5
Rental Prices of Investment									
Consumer Durables (%)....	22.4	22.6	21.8	21.5	20.9	20.1	19.5	18.8	18.2
Single Family Starts (%).	17.5	16.0	15.2	14.9	13.5	13.2	13.0	12.8	12.7
Multi Family Starts (%)..	20.0	18.6	17.6	17.6	15.9	15.5	15.2	15.0	14.9
Producer Durables (%)....	19.4	19.0	18.5	21.9	21.9	21.5	20.9	20.2	19.6
Nonres Strucutres (%)....	18.0	18.4	18.0	20.6	21.2	21.4	21.1	20.7	20.5
Business Inventories (%).	9.5	11.0	8.3	6.8	6.3	5.3	4.9	4.6	4.4
Real Capital Stocks (bil $72)									
Consumer Durables........	612.3	648.8	690.7	728.1	765.8	801.4	838.5	877.8	918.8
Residential..............	1180.2	1211.8	1241.7	1269.1	1302.0	1337.3	1373.3	1410.5	1447.9
Producer Durables........	680.0	724.2	770.1	814.7	853.4	887.8	922.7	959.4	1001.0
Nonres Structures........	663.4	682.7	705.2	726.1	747.4	769.2	791.3	813.3	833.7
Business Inventories.....	336.5	361.3	369.8	382.0	399.8	424.1	453.3	482.5	509.3

* Levels are for 4th qtr of year

Source: Laurence H. Meyer & Assoc

Table 1: Comparison of the Present Value of Cost Recovery Allowances for Computer Equipment in the United States and Other Countries[1]

4 Percent Real Return			8 Percent Real Return			12 Percent Real Return		
Country	Present Value	Rank	Country	Present Value	Rank	Country	Present Value	Rank
Luxemburg	137.8	1	Luxembourg	130.5	1	Luxembourg	124.2	1
Spain	118.9	2	Spain	110.9	2	Spain	104.0	2
Belgium	97.7	3	Belgium	94.8	3	Belgium	92.1	3
US-ACRS/ITC	96.7		US-ACRS/ITC	89.4		US-ACRS/ITC	83.2	
Hong Kong	88.6	4	Hong Kong	84.7	4	Hong Kong	81.5	4
Italy	87.7	5	Italy	83.1	5	Italy	78.9	5
Denmark	87.3	6	Denmark	79.1	6	Sweden	73.1	6
Sweden	83.9	7	Sweden	78.2	7	Denmark	72.5	7
US-W&M	82.4		US-W&M	76.1		US-W&M	70.8	
France	82.4	8	France	76.1	8	France	70.8	8
Switzerland	81.4	9	Switzerland	75.1	9	Switzerland	69.7	9
West Germany	80.6	10	South Korea	74.0	10	South Korea	68.4	10
South Korea	80.6	10	Taiwan	74.0	10	Taiwan	68.4	10
Taiwan	80.6	10	West Germany	73.8	12	West Germany	67.9	12
Japan [2]	77.9	13	Japan [2]	70.8	13	Japan [2]	64.8	13
Canada	76.6	14	Canada	69.3	14	United Kingdom	63.6	14
United Kingdom	76.4	15	United Kingdom	69.3	14	Canada	63.2	15

[1] Class two of the Ways and Means Committee (US-W&M) Staff tax reform incentive depreciation system includes, for example: computer equipment, data handling equipment, telephone switching equipment, heavy trucks, equipment used in construction, drilling of oil and gas wells, and cutting timber. Calculations for the comparison were made with respect to computer equipment.

[2] Although Japan's capital cost system is inferior to that of the U.S., research by Dr. John B. Shoven, Stanford University, suggests that when all factors affecting the cost of capital are considered, Japanese investors enjoy a substantial advantage over their U.S. competitors. Japan's advantage over the U.S. stems from: (1) much lower taxes on capital income at the individual level; (2) individual's almost unlimited ability to deduct savings from taxable income; (3) reduced corporate tax rates on income paid out as dividends; and (4) much higher debt/equity ratios than in the U.S.

NOTE: The computations assume an inflation rate of 5 percent and a 4, 8, or 12 percent real rate of return. Depreciation is computed on an asset placed in service by a calendar year taxpayer on July 1, 1986 without regard to the mid-month convention.

Source: Arthur Andersen & Co

Table 2: Comparison of Nominal Cost Recovery Allowances for Computer Equipment as a Percent of Cost for the United States and Other Countries1/

1 Year			3 Years			5 Years		
Country	Amount	Rank	Country	Amount	Rank	Country	Amount	Rank
Luxembourg	85.4	1	Luxembourg	122.7	1	Luxembourg	151.3	1
Belgium	71.0	2	Belgium	105.0	2	Spain	122.4	2
Hong Kong	68.5	3	Spain	101.2	3	US-ACRS/ITC	117.4	
Spain	57.9	4	Italy	99.0	4	Belgium	105.0	3
Italy	33.0	5	Hong Kong	84.6	5	Italy	100.0	4
US-ACRS/ITC	32.4		US-ACRS/ITC	75.4		Sweden	100.0	4
Sweden	30.0	6	US-W&M	71.2		West Germany	100.0	4
Denmark	25.0	7	France	71.2	6	US-W&M	94.7	
United Kingdom	25.0	7	Switzerland	71.2	6	France	94.2	7
US-W&M	20.0		Sweden	71.0	8	Hong Kong	92.4	8
France	20.0	9	South Korea	67.5	9	Switzerland	89.6	9
Switzerland	20.0	9	Taiwan	67.5	9	Denmark	88.1	10
South Korea	18.5	11	Denmark	66.0	11	South Korea	87.1	11
Taiwan	18.5	11	Japan[2]	61.0	12	Taiwan	87.1	11
Japan[2]	16.0	13	West Germany	60.5	13	Japan[2]	81.9	13
Canada	15.0	14	Canada	58.4	14	Canada	79.6	14
West Germany	15.0	14	United Kingdom	57.8	15	United Kingdom	76.3	15

[1] Class two of the Ways and Means Committee (US-W&M) Staff tax reform incentive depreciation system includes, for example: computer equipment, data handling equipment, telephone switching equipment, heavy trucks, equipment used in construction, drilling of oil and gas wells, and cutting timber. Calculations for the comparison were made with respect to computer equipment. Class two equipment is subject to double declining balance depreciation over a five-year recovery period, switching to straight-line at the optimal point.

2/Although Japan's capital cost system is inferior to that of the U.S., research by Dr. John B. Shoven, Stanford University, suggests that when all factors affecting the cost of capital are considered, Japanese investors enjoy a substantial advantage over their U.S. competitors. Japan's advantage over the U.S. stems from: (1) much lower taxes on capital income at the individual level; (2) individual's almost unlimited ability to deduct savings from taxable income; (3) reduced corporate tax rates on income paid out as dividends; and (4) much higher debt/equity ratios than in the U.S.

NOTE: Rank shown for all foreign countries assumes current law for the United States (ACRS/ITC).
Source: Arthur Andersen & Co.

Table 1: Comparison of the Present Value of Cost Recovery Allowances for Mining Equipment in the United States and Other Countries[1]

4 Percent Real Return			8 Percent Real Return			12 Percent Real Return		
Country	Present Value	Rank	Country	Present Value	Rank	Country	Present Value	Rank
Luxemburg	143.8	1	Luxembourg	138.5	1	Luxembourg	133.7	1
Spain	118.9	2	Spain	110.9	2	Spain	104.0	2
South Korea	102.0	3	Belgium	94.6	3	Belgium	90.1	3
Belgium	99.6	4	South Korea	94.3	4	South Korea	87.7	4
US-ACRS/ITC	96.7		US-ACRS/ITC	89.4		US-ACRS/ITC	83.2	
Canada	89.8	5	Canada	82.6	5	Canada	76.7	5
Denmark	87.3	6	Italy	80.8	6	Hong Kong	76.7	5
Italy	86.0	7	Hong Kong	80.3	7	Italy	76.2	7
Hong Kong	84.8	8	Denmark	79.1	8	Sweden	73.1	8
Sweden	83.9	9	Sweden	78.2	9	Denmark	72.5	9
France	82.4	10	France	76.1	10	France	70.8	10
Switzerland	81.4	11	Switzerland	75.1	11	Switzerland	69.7	11
Japan [2]	80.2	12	West Germany	73.7	12	West Germany	69.0	12
West Germany	79.7	13	Japan [2]	73.6	13	Japan [2]	68.0	13
United Kingdom	76.3	14	United Kingdom	69.3	14	United Kingdom	63.6	
Taiwan	71.9	15	Taiwan	63.5	15	Taiwan	56.9	15
US-W&M	70.4		US-W&M	61.7		US-W&M	54.8	

1 Class four of the Ways and Means Committee (US-W&M) staff tax incentive depreciation system includes, for example: mining equipment, rail cars and assets used in manufacture of pulp and paper, glass products, primary nonferrous metals and foundry and steel mill products. Calculations for the comparison were made with respect to mining equipment.

2/Although Japan's capital cost system is inferior to that of the U.S., research by Dr. John B. Shoven, Stanford University, suggests that when all factors affecting the cost of capital are considered, Japanese investors enjoy a substantial advantage over their U.S. competitors. Japan's advantage over the U.S. stems from: (1) much lower taxes on capital income at the individual level; (2) individual's almost unlimited ability to deduct savings from taxable income; (3) reduced corporate tax rates on income paid out as dividends; and (4) much higher debt/equity ratios than in the U.S.

NOTE: The computations assume an inflation rate of 5 percent and a 4, 8,or 12 percent real rate of return. Depreciation is computed on an asset placed in service by a calendar year taxpayer on July 1, 1986 without regard to the mid-month convention.

Source: Arthur Andersen & Co.

Table 4: Comparison of Nominal Cost Recovery Allowances for Mining Equipment as a Percent of Cost for the United States and Other Countries 1/

1 Year			3 Years			5 Years		
Country	Amount	Rank	Country	Amount	Rank	Country	Amount	Rank
uxembourg	119.8	1	Luxembourg	137.0	1	Luxembourg	154.2	1
ong Kong	64.0	2	Spain	101.2	2	Spain	122.4	2
pain	57.9	3	Belgium	97.0	3	US-ACRS/TTC	117.4	
eligum	53.0	4	Italy	87.0	4	South Korea	114.2	3
est Germany	52.5	5	South Korea	80.5	5	Beligum	113.0	4
outh Korea	35.5	6	Hong Kong	77.0	6	Italy	100.0	5
anada	33.4	7	US-ACRS/TTC	75.4		Sweden	100.0	5
S-ACRS/TTC	32.4		Canada	73.7	7	France	94.2	7
weden	30.0	8	France	71.2	8	Canada	93.4	8
taly	29.0	9	Switzerland	71.2	8	Switzerland	89.6	9
enmark	25.0	10	Sweden	71.0	10	Denmark	88.1	10
nited Kingdom	25.0	10	Japan 2	67.5	11	Japan 2	87.1	11
rance	20.0	12	Denmark	66.0	12	Hong Kong	85.3	12
witzerland	20.0	12	West Germany	62.5	13	United Kingdom	76.3	13
apan 2	18.5	14	United Kingdom	57.8	14	West Germany	72.5	14
aiwan	11.3	15	Taiwan	46.9	15	US-W&M	63.1	
S-W&M	10.0		US-W&M	42.4		Taiwan	68.[illegible]	15

lass four of the Ways and Means Committee (US-W&M) staff tax incentive depreciation system includes, for example: ining equipment, rail cars and assets used in manufacture of pulp and paper, glass products, primary nonferrous etals and foundry and steel mill products. Calculations for the comparison were made with respect to mining equipment. lass four equipment is subject to double declining balance depreciation over a ten-year recovery period, switching o straight-line at the optimal point.

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OTE: Rank shown for all foreign countries assumes current law for United States (ACRS/TTC).
ource: Arthur Andersen & Co.

Table 5. Comparison of the Present Value of Cost Recovery Allowances for Manufacturing Equipment in the United States and Other Countries[1]

4 Percent Real Return			8 Percent Real Return			12 Percent Real Return		
Country	Present Value	Rank	Country	Present Value	Rank	Country	Present Value	Rank
uxembourg	139.4	1	Luxembourg	132.6	1	Luxembourg	126.8	1
pain	114.2	2	Belgium	105.5	2	Belgium	99.1	2
elgium	110.1	3	Spain	104.3	3	Spain	98.4	3
anada	100.3	4	Canada	95.6	4	Canada	91.4	4
S-ACRS/ITC	96.7		US-ACRS/ITC	89.4		US-ACRS/ITC	83.2	
ong Kong	88.6	5	Hong Kong	84.7	5	Hong Kong	81.5	5
enmark	87.3	6	Denmark	79.1	6	Sweden	73.1	6
weden	83.9	7	Sweden	78.2	7	Denmark	72.5	7
taly	83.1	8	Italy	77.1	8	Italy	71.9	8
rance	82.4	9	France	76.1	9	France	70.8	9
est Germany	78.3	10	West Germany	71.0	10	West Germany	64.9	10
witzerland	76.5	11	United Kingdom	69.3	11	United Kingdom	63.6	11
nited Kingdom	76.4	12	Switzerland	69.2	12	Switzerland	63.2	12
. Korea	74.7	13	S. Korea	67.1	13	S. Korea	60.8	13
apan[2]	71.6	14	Japan[2]	64.2	14	Japan[2]	58.3	14
S-W&M	70.4		US-W&M	61.7		US-W&M	54.8	
aiwan	68.5	15	Taiwan	60.4	15	Taiwan	53.9	15

lass four of the Ways and Means Committee (US-W&M) staff tax incentive depreciation system includes, for example: ining equipment, rail cars and assets used in manufacture of pulp and paper, glass products, primary nonferrous etals and foundry and steel mill products. Calculations for the comparison were made with respect to light manufacturing extile equipment.

[2] Although Japan's capital cost system is inferior to that of the U.S., research by Dr. John B. Shoven, Stanford University, suggests that when all factors affecting the cost of capital are considered, Japanese investors enjoy a substantial advantage over their U.S. competitors. Japan's advantage over the U.S. stems from: (1) much lower taxes on capital income at the individual level; (2) individual's almost unlimited ability to deduct savings from taxable income; (3) reduced corporate tax rates on income paid out as dividends; and (4) much higher debt/equity ratios than in the U.S.

NOTE: The computations assume an inflation rate of 5 percent and a 4, 8, or 12 percent real rate of return. Depreciation is computed on an asset placed in service by a calendar year taxpayer on July 1, 1986 without regard to the mid-month convention.

Source: Arthur Andersen & Co.

Table 6: Comparison of Nominal Cost Recovery Allowances for Manufacturing Equipment As a Percent of Cost for the United States and Other Countries.[1]

1 Year			3 Years			5 Years		
Country	Amount	Rank	Country	Amount	Rank	Country	Amount	Rank
Luxembourg	89.7	1	Luxembourg	133.7	1	Luxembourg	149.6	1
Hong Kong	68.5	2	Canada	112.5	2	Belgium	125.9	2
Spain	55.4	3	Belgium	105.7	3	US-ACRS/ITC	117.4	
Belgium	54.6	4	Spain	93.7	4	Spain	115.2	3
Canada	42.7	5	Hong Kong	84.6	5	Canada	112.5	4
US-ACRS/ITC	32.4		US-ACRS/ITC	75.4		Sweden	100.0	5
Sweden	30.0	6	Italy	75.0	6	Italy	95.0	6
Denmark	25.0	7	France	71.2	7	France	94.2	7
Italy	25.0	7	Sweden	71.0	8	Hong Kong	92.4	8
United Kingdom	25.0	7	Denmark	66.0	9	Denmark	88.1	9
Japan[2]	20.6	10	Switzerland	58.4	10	West Germany	80.8	10
France	20.0	11	West Germany	58.4	10	Switzerland	79.6	11
Switzerland	15.0	12	United Kingdom	57.8	12	United Kingdom	76.3	12
West Germany	15.0	12	South Korea	54.1	13	South Korea	75.6	13
S. Korea	13.6	14	Japan[2]	49.9	14	Japan[2]	68.4	14
Taiwan	10.3	15	Taiwan	43.4	15	Taiwan	64.3	15
US-W&M	10.0		US-W&M	42.4		US-W&M	63.1	

[1] Class four of the Ways and Means Committee (US-W&M) staff tax reform option incentive depreciation system includes, for example: mining equipment, rail cars and assets used in manufacture of pulp and paper, glass products, primary non-ferrous metals and foundry and steel mill products. Calculations for the comparison were made with respect to light manufacturing textile equipment. Class four equipment is subject to double declining balance depreciation over a ten year recovery period, switching to straight line at the optimal point.

2/Although Japan's capital cost system is inferior to that of the U.S., research by Dr. John B. Shoven, Stanford University, suggests that when all factors affecting the cost of capital are considered, Japanese investors enjoy a substantial advantage over their U.S. competitors. Japan's advantage over the U.S. stems from: (1) much lower taxes on capital income at the individual level; (2) individual's almost unlimited ability to deduct savings from taxable income; (3) reduced corporate tax rates on income paid out as dividends; and (4) much higher debt/equity ratios than in the U.S.

NOTE: Rank shown for all foreign countries assumes current law for the United States (ACRS/ITC).

Source: Arthur Andersen & Co.

Table 7: Comparison of the Present Value of Cost Recovery Allowances for Electric Utility Transmission and Distribution Pla in the United States and Other Countries[1]/

4 Percent Real Return			8 Percent Real Return			12 Percent Real Return		
Country	Present Value	Rank	Country	Present Value	Rank	Country	Present Value	Rank
Luxembourg	124.1	1	Luxembourg	114.1	1	Luxembourg	106.2	1
Spain	107.2	2	Spain	97.4	2	Beligum	90.1	2
Belgium	99.6	3	Beligum	94.6	3	Spain	89.8	3
South Korea	91.1	4	South Korea	81.1	4	Sweden	73.1	4
Sweden	83.9	5	Sweden	78.2	5	South Korea	73.1	4
Italy	82.0	6	Italy	75.8	6	Italy	70.4	6
Denmark	76.5	7	United Kingdom	69.3	7	United Kingdom	63.6	7
United Kingdom	76.3	8	France	66.0	8	Fance	59.5	8
US-ACRS/ITC	74.3		US-ACRS/ITC	63.7		US-ACRS/ITC	56.0	
France	74.0	9	Denmark	61.9	9	Denmark	51.5	9
Hong Kong	66.5	10	Hong Kong	56.9	10	Hong Kong	49.4	10
Taiwan	61.5	11	Taiwan	52.0	11	Taiwan	45.1	11
Switzerland	54.4	12	Switzerland	45.1	12	Switzerland	38.6	12
West Germany	52.4	13	West Germany	42.9	13	West Germany	36.4	13
US-W&M	43.1		US-W&M	33.8		US-W&M	27.8	
Japan [2]	40.3	14	Japan [2]	31.7	14	Japan [2]	26.1	14
Canada	39.1	15	Canada	30.9	15	Canada	25.5	15

[1] Class nine of the Ways and Means Committee (US-W&M) Staff tax reform incentive depreciation system includes, for example: electric utility transmission and distribution plant, railroad structures and gas utility distribution facilities. Class Calculations for the comparison were made with respect to electric utility transmission and distribution plant.

2/Although Japan's capital cost system is inferior to that of the U.S., research by Dr. John B. Shoven, Stanford University, suggests that when all factors affecting the cost of capital are considered, Japanese investors enjoy a substantial advantage over their U.S. competitors. Japan's advantage over the U.S. stems from: (1) much lower taxes on capital income at the individual level; (2) individual's almost unlimited ability to deduct savings from taxable income; (3) reduced corporate tax rates on income paid out as dividends; and (4) much higher debt/equity ratios than in the U.S.

NOTE: The computations assume an inflation rate of 5 percent and a 4, 8, or 12 percent real rate of return. Depreciation is computed on asset placed in service by a calendar year taxpayer on July 1, 1986 without regard to the mid-month convention.

Source: Arthur Andersen & Co.

Table 8: Comparison of Nominal Cost Recovery Allowances for Electric Utility Transmission and Distribution Plant as a Percent of Cost for the United States and Other Countries 1/

12/2

1 Year			3 Years			5 Years		
Country	Amount	Rank	Country	Amount	Rank	Country	Amount	Rank
Luxembourg	76.8	1	Belgium	97.0	1	Belgium	113.0	1
Belgium	53.0	2	Luxembourg	94.0	2	Luxembourg	111.2	2
Spain	51.6	3	Spain	80.8	3	Spain	100.6	3
South Korea	30.2	4	Italy	72.0	4	Sweden	100.0	4
Sweden	30.0	5	Sweden	71.0	5	Italy	90.0	5
United Kingdom	25.0	6	United Kingdom	57.8	6	South Korea	78.2	6
Italy	24.0	7	South Korea	54.2	7	United Kingdom	76.3	7
US-ACRS/ITC	22.4		France	50.8	8	France	72.3	8
France	12.5	8	US-ACRS/ITC	41.4		US-ACRS/ITC	56.4	
Hong Kong	10.0	9	Taiwan	31.6	9	Hong Kong	50.0	9
Denmark	8.0	10	Hong Kong	30.0	10	Taiwan	49.7	10
Taiwan	7.1	11	Denmark	25.2	11	Denmark	44.2	11
Switzerland	5.5	12	Switzerland	25.1	12	Switzerland	40.7	12
West Germany	5.0	13	West Germany	23.1	13	West Germany	37.7	13
US-W&M	3.3		US-W&M	15.8		US-W&M	26.6	
Japan 2	3.1	14	Japan 2	14.7	14	Japan 2	25.0	14
Canada	3.0	15	Canada	14.3	15	Canada	24.3	15

[1] Class nine of the Ways and Means Committee (US-W&M) Staff tax reform incentive depreciation system includes, for example: electric utility transmission and distribution plant, railroad structures and gas utility distribution facilities. Calculations for the comparison were made with respect to electric utility transmission and distribution plant. Class nine equipment is subject to a double declining balance depreciation over a thirty-year recovery period switching to straight-line at the optimal point.

/Although Japan's capital cost system is inferior to that of the U.S., research by Dr. John B. Shoven, Stanford University, suggests that when all factors affecting the cost of capital are considered, Japanese investors enjoy a substantial advantage over their U.S. competitors. Japan's advantage over the U.S. stems from: (1) much lower taxes on capital income at the individual level; (2) individual's almost unlimited ability to deduct savings from taxable income; (3) reduced corporate tax rates on income paid out as dividends; and (4) much higher debt/equity ratios than in the U.S.

NOTE: Rank shown for all foreign countries assumes current law for the United States (ACRS/ITC).

Source: Arthur Andersen & Co.

Senator GORTON. You did. And you did so very eloquently.

Mr. Hostetler.

STATEMENT OF ROBERT D. HOSTETLER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, CTS CORP., ON BEHALF OF THE ELECTRONIC INDUSTRIES ASSOCIATION

Mr. HOSTETLER. Thank you, Mr. Chairman. Good morning. I'm Bob Hostetler of CTS Corp. First, Mr. Chairman, I must apologize for bringing in this awful weather from the Midwest. I am here as vice chairman of the Electronic Industries Association. Also with me is Pete McCloskey, the president of Electronic Industries Association.

CTS is a medium-sized company in the electronic components business, with about 7,000 employees, of which over 5,000 are in the United States. EIA, of course, is a full-service electronics industry association.

I recently participated in a meeting of the board of governors of our association. Around the table were perhaps 60 CEO's of medium and large companies, and companies from consumer and industrial and military electronics businesses.

We had quite a discussion. Previous discussions of this group have primarily focused on what we have to do as an industry and as individual companies to compete in the international environment that we find ourselves in today.

We've identified the things that we have to do in quality and in higher productivity, and the kinds of things we've got to do for customers to be more competitive. Of course, we're fighting this international battle primarily on our own turf in the United States, because our international competitors tend to look at the U.S. market as their No. 1 market.

TRADE DEFICIT OF $11 TO $12 BILLION LAST YEAR

It's a fight we're not doing too well in. We haven't yet won. We were an industry that contributed greatly to the trade surpluses of the past. And it looks like last year the trade deficit in electronics was $11 to $12 billion. We've got a big job to do there.

In our most recent meeting, however, we focused on H.R. 3838. Regardless of the short-term impact of that bill on our individual companies; that is, in some cases, it was good; in some cases, it was bad in the short term, we came away very concerned that this bill would undermine our efforts to compete internationally and will thus add to that trade deficit problem.

The bill attacks the very issues that we think we need to concentrate on to be successful. That is, research and development and capital investment. We think that the remainder of this century will see greater competition for the United States in the global marketplace, particularly in electronics.

Therefore, we think that the Nation's Tax Code must be evaluated from the perspective of American businesses' ability to compete in that international marketplace. This places a premium on proinvestment and procompetition incentives in the Tax Code; and demands that the ability to form capital be enhanced, not eroded.

Therefore, EIA does not favor the House-passed bill. That bill contains negative elements which we believe would contribute to a further deindustrialization of our Nation's economy.

We support the concept of a national tax reform to achieve lower rates and a broader base, along with a greater level of simplicity and fairness. But we're very concerned by the methods used in the House bill to reconcile lower rates and revenue neutrality.

FAVOR BROAD-BASED CONSUMPTION TAX

Rather than eliminating the investment tax credit and stretching depreciation, we would suggest paying for individual and corporate rate reductions through some form of a broad-based consumption tax. I'll elaborate on that in a minute.

There's, of course, additional pressure on this debate of the need to bring the budget deficit under control. We have supported Gramm-Rudman-Hollings, feeling that this landmark legislation forces us all into a new era of Federal fiscal responsibility. I'd like to highlight two key provisions of the current tax bill, focusing on the support of R&D and on capital expenditures that EIA feels must be retained for trade policy reasons.

R&D activities are inherently risky but they are the lifeblood of technological superiority. In addition, I think it's widely recognized that the benefits that come from R&D are not enjoyed just by the corporation that's undergoing the R&D but are spread throughout the economy.

The clear need to create incentives for such important activities caused Congress to put into effect the 25-percent incremental R&D tax credit in 1981.

The House, of course, would extend this credit for 3 years, but only at a 20-percent rate. We urge the Senate to restore the full 25-percent credit and to make it permanent.

There are a couple of other provisions that can affect the R&D issues. That includes, first, the question of R&D expenses being treated as a preference item when it comes to the alternative corporate minimum tax. And, second, the so-called section 861. We're concerned about those as well because we think they discourage R&D in the United States.

With regard to capital expenditures, we feel that the combination of the elimination of the investment tax credit and the modifications of depreciation rates and schedules goes against what we must do today in electronics, which is to invest heavily in modern equipment.

Of course, we don't fund the desirable lower rates through increased taxes on capital expenditures in R&D. We recognize that the tax dollars have to come from somewhere else. We believe that the place to get those tax dollars is from a broad-based consumption tax. A broad-based tax is defined variously as a value-added tax or a business transfer tax.

This would offset the antieconomic growth and antisavings bias of our current income tax system. It would make tax reform possible without resorting to base broadeners which do not meet the objectives of fairness, simplicity, and economic growth.

CTS CORP. SITUATION

Now, if I may, I would like to speak somewhat more personally for CTS Corp., not the industry as a whole, but CTS and its shareholders and employees.

Now, 20 years ago, we were a $100 million company, but we sold virtually all of our components into the consumer electronics industry—the TV business—a business that I think you well know has now been essentially taken over by our friends from across the Pacific.

That essentially wiped out the entire market that our company had. Despite that loss, our sales today are $300 million. We have good potential for growth, and good potential for growth in employment within the United States. We have accomplished this by developing new products for other markets in electronics, and by substantially increasing our productivity and quality for our customers.

I think we recognize the job we must do to compete internationally and we're working hard to accomplish that job. But we would ask that you support us by designing tax legislation that would encourage investment in employment in the United States and worldwide competitiveness for U.S. companies.

Our company and, indeed, our industry and the country, cannot afford to lose any additional segments of the electronics industry. And we need your help.

Gentlemen, your task is not an easy one. If it were just as simple as lowering rates and broadening the base, it would surely have been accomplished a long time ago.

Our system is complex, but, wholesale elimination of the carefully crafted provisions in the Tax Code is not our answer to simplicity. We have to continually fine tune the tax laws in light of our national priorities.

Once again, I would suggest that the ability to form the necessary capital and to maintain our competitive position in world markets are two fundamental national priorities.

Thank you.

[The complete prepared statement follows:]

Electronic Industries Association

Statement of

Robert D. Hostetler
President and CEO, CTS Corporation
on behalf of the
ELECTRONIC INDUSTRIES ASSOCIATION

Before the
Committee on Banking, Housing, and Urban Affairs
United States Senate

February 4, 1986

2001 Eye Street, N.W. · Washington, D.C. 20006 · (202) 457-4900 · TWX: 710-822-0148

Mr. Chairman and members of the committee, my name is Robert Hostetler, I am President and Chief Executive Officer of CTS Corporation. I am here today on behalf of the Electronic Industries Association where I serve as Vice Chairman of the Board of Governors. Accompanying me this morning is EIA's President, Pete McCloskey. We are pleased to have this opportunity to present our statement.

CTS designs and manufactures a broad range of electronic components and subsystems for major firms in the electronics industry. We are a public company, with sales of $300 million. 20 of our 26 plants are in the United States as are 5,500 of our 7,000 employees.

EIA, with 500 member companies and more than 1,000 participating companies, is the full-service national trade association representing the entire spectrum of companies involved in the manufacture of electronic components, parts, systems and equipment for communications, industrial, government and consumer end uses.

Whether measured by international trade, employment or research and development, the electronic industries represent an important force in the world economy. U.S. factory sales of electronic equipment, systems and components exceeded $190 billion in 1985. Our industry is very international trade oriented. Total trade in electronics (imports plus exports) through November 1985 topped $68 billion. Of this total, $29 billion, or 42%, was exported. The days of a large domestic market all to ourselves are clearly over.

Due in large part to the strength of the dollar relative to other currencies, as well as various market access problems, U.S. trade in electronics showed a negative balance-of-trade through November 1985 of $11 billion. This alarming number is over thirteen times the industry's first trade deficit of $875 million in 1983. Further, these increasing deficits are occurring although our exports are increasing each year. Figures just released for U.S.

trade as a whole show a record deficit of $148.5 billion in 1985. The United States has become a debtor nation; we are mortgaging our future standard of living with interest and debt service payments.

EIA is concerned that present tax reform proposals will exacerbate the U.S. trade deficit problem.

The remainder of this century will see heightened competition for the United States in the global marketplace. Consequently, we feel that reform of the nation's tax code must be evaluated from the perspective of American business' ability to compete in that international marketplace. This places a premium on pro-investment and pro-competition incentives in the tax code. The ability to form capital must be enhanced, not eroded. Therefore, EIA does not favor the House passed tax bill, H.R. 3838. That bill contains negative elements which would contribute to a further de-industrialization of our nation's economy.

EIA supports the concept of national tax reform to achieve lower rates and a broader base, along with greater levels of simplicity and fairness. However, we are very concerned by the methods used in the House bill to reconcile lower rates and revenue neutrality. A shift of tax burden of the magnitude of $140 billion over 5 years to corporations to make up the revenues lost through rate reductions will dramatically hinder capital formation. Now, more than ever, the pro-economic growth and pro-capital formation mechanisms of our tax code are needed.

Rather than eliminating the investment tax credit and stretching depreciation rates, we would suggest paying for individual and corporate rate reductions through some form of a broad based consumption tax. We'll elaborate on this later.

Additional pressure is exerted on this debate by the need to bring our budget deficit under control.

Government cannot habitually spend more than it collects without leading us into one of two eventualities: either inflation which debases the currency and drains the savings of citizens; or borrowing more of the capital which should be available for industry, thereby forcing interest rates higher and higher.

Over two years ago, EIA adopted a platform calling for budgetary moderation by Congress and the Administration; for moderation through spending reduction far more than through tax increase, and for reduction throughout the programs of all federal departments. We supported the Gramm-Rudman-Hollings budget reform bill, feeling that this landmark legislation forces us into a new era of federal fiscal responsibility.

It is now up to the Administration and the Congress to act forcefully to reduce the federal budget deficit in order to meet the bill's mandate. The success of this legislation will be measured by Congress' ability to step up to the challenge by making the hard choices so it will not be necessary to utilize the drastic remedy inherent in the law.

I would like to highlight a few key provisions of the current tax law, including some provisions which recently expired, that EIA feels must be retained for trade policy reasons.

R&D Tax Credit

R&D activities are inherently risky, but they are the lifeblood of technological superiority. In addition, it is widely recognized that the benefits which accrue from R&D are not enjoyed solely by the corporation which undertakes the activity. The clear need to create incentives for such important activities caused Congress to enact a 25% incremental R&D tax credit in 1981.

EIA, along with other members of the Coalition for the Advancement of Industrial Technology (CAIT), a broad based coalition of companies, trade associations and universities working to make the credit permanent, commissioned a study entitled "The Need for A Permanent Tax Credit for Industrial Research and Development." Prepared by Martin Bailey and Robert Lawrence of the Brookings Institution, along with Data Resources, Inc., this economic assessment predicts the amount of additional GNP that the R&D tax credit is likely to generate. Under the most conservative assumptions, it concludes that a permanent R&D tax credit would generate an extra $1.2 billion a year in 1986 in real GNP and $2.9 billion in 1991.

Under the "best case" scenario, an R&D tax credit would yield $7.5 billion in annual GNP increases in constant dollars in 1986 and $17.7 billion by 1991. GNP increases of this magnitude would produce taxable revenues that should more than offset treasury revenue losses due to making the credit permanent.

The House bill would extend the R&D credit for 3 years at only a 20 percent rate. We urge the Senate to restore the full 25% credit and to make it permanent.

Finally, it is very important that if an alternative corporate minimum tax is adopted, that R&D expenditures not be treated as a preference item.

There is nothing artificial about the deduction for R&D expenditures. Each R&D deduction represents an amount actually paid. Including R&D expenses as a tax preference does not stem any tax abuse it merely limits the funds available for R&D.

861

Allocation requirements under Section 1.861-8 of the Internal Revenue Code are a penalty for doing R&D in the U.S. and an incentive to move R&D activities abroad. The issue of allocating domestic R&D expenses against foreign source income has far-reaching trade implications. We cannot afford to further jeopardize domestic jobs or domestic research and development technologies to overseas competitors. Furthermore, we must permit U.S. companies to plan on a long-term basis. Under current law, temporary moratoriums on R&D do not permit companies to plan the utilization of human and capital resources on a long-term basis. A permanent moratorium would permit U.S. companies to plan and compete in a more flexible manner.

The House bill provides only a small improvement over the prior law Treasury allocation of R&D to foreign sources and only for a temporary, two-year period. It is thus crucial that the Senate make permanent the moratorium which it has adopted and extended since 1981 on any allocaton of R&D expenses to foreign income.

Investment Tax Credit

A tax code with an anti-capital bias such as existed prior to 1981 would be devastating to U.S. industry in the current competitive environment. Elimination of the ITC increases the cost of capital for the very companies who are struggling to maintain their competitiveness against foreign companies, most of whom operate under more favorable capital formation conditions. Elimination of the ITC will make it more difficult for already hardpressed U.S. companies to compete.

Foreign Tax Credit

While the President's proposal and the House Bill each treat the foreign tax credit quite differently, each substantially limits the use of foreign tax credits by U.S. business. Both proposals would have the effect of preventing taxpayers from ever claiming a foreign tax credit for some portion of the foreign taxes they actually pay even where foreign tax rates are lower than the U.S. rate. This result not only harms American companies' ability to compete but also violates the original Treasury objective of maintaining strict tax neutrality between U.S. and foreign taxes. None of America's trading partners place restrictions like those proposed on its nationals. The proposed rules would cause harm well beyond the modest amounts of revenue they seek to raise. Not only would they increase the costs of doing business overseas but they would introduce a level of statutory complexity which would entail substantial compliance costs for all affected taxpayers.

Depreciation Rates and Schedules

Any new depreciation system must be structured to provide proportionate levels of acceleration for short-lived as well as long-lived equipment. Both the President's proposal and the House bill provide rates and lives far less generous than those allowed to nationals of our principal trading partners, and do not fairly take into account replacement costs.

Elimination of Foreign Source Income for Exports and Reduction in FSC Benefits

H.R. 3838 would eliminate or significantly reduce two important incentives for U.S. exports. First, the sourcing rule that treats part of the income from U.S. exports as foreign-source income would be eliminated. Second, the percentage of export income exempt from tax under the Foreign Sales Corporation (FSC) provisions would be reduced from 15% to 13%.

The clear impact of these provisions would be a substantial tax increase on United States exports. At a time when Congress is searching for effective means to reduce our record balance-of-trade deficit, adopting such provisions would be counter-productive.

Congress recognized the need to provide effective tax incentives for U.S. exports when it adopted the FSC provisions in 1984. Lowering the benefits available under those provisions would considerably reduce their stimulative effect.

The sourcing rule was affirmed and modified in 1984 by Congress when it adopted the FSC provisions. This sourcing rule provides an incentive for U.S. exporters by treating a portion of their export income as foreign-source income, which improves their ability to utilize foreign tax credits. This incentive has not been challenged under GATT, which was a major difficulty under the DISC rules.

Completed Contract Method of Accounting

The Completed Contract Method of Accounting (CCM) is a well established, and reasonable method of measuring income or loss from long-term contracts. The House bill eliminates the Completed Contract Method of Accounting which is used by taxpayers who provide state of the art technology, under long-term projects, to report taxable income with the accuracy required by our tax system. History has proven that the accrual and percentage of completion methods are inadequate and can lead to income manipulation and tax avoidance in the unique circumstances of this industry. The full revenue impact of the overhaul of CCM in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) has not been recognized because the new rules were phased-in over three years. The CCM after TEFRA does not permit contractors to avoid tax. TEFRA is fully effective in 1985 and contractors will report substantial amounts of taxable income over the next four years.

Broad Based Consumption Taxes

It is obvious that among the forces at work in this overall debate — tax reform and revenue neutrality in conjunction with efforts to balance the budget — is the clear need to raise additional revenues to achieve our goals.

EIA recommends that some form of a broad based consumption tax be considered for use, together with reductions in federal spending to narrow the deficit. Such a consumption tax should not be rationalized as affording increased spending, and must contain safeguards against future rate increases to afford more spending.

A broad based consumption tax such as the "value added tax" or "business transfer tax" would ameliorate the anti-economic growth and anti-saving bias of our current income tax system. It would make tax reform possible without resorting to base broadeners which do not meet the objectives of fairness, simplicity and economic growth.

Conclusion

If I may, I would like to speak somewhat more personally for a moment for CTS, its shareholders and employees.

Twenty years ago, we were a $100 million company primarily building components for sale to major manufacturers of consumer electronic equipment like TV sets. For a variety of reasons our friends from across the Pacific essentially took over that market, as you know, leaving our company with very little opportunity to sell our products, except from our Far East plants.

Despite this loss of nearly all our $100 million in sales of 20 years ago, we are toady a $300 million company with good growth prospects. We have accomplished this by developing new products for other electronic markets and by substantially increasing our productivity and quality for our customers. We recognize the job we must do to compete internationally and are working hard to accomplish that job.

We would ask that you support us by designing tax legislation that would encourage investment and employment in the U.S. and worldwide competitiveness for U.S. companies. Our company — and indeed our industry and the country — cannot afford to lose any additional segments of the electronics industry. And we need your help.

Senators, your task is not an easy one. Were it as simple as lowering rates and broadening the base, I suppose it would have been accomplished years ago. Our system is complex, but wholesale elimination of the carefully crafted provisions in the tax code is not our answer to simplicity. We have to continually fine tune the tax laws in light of our national priorities. And, once again, I would suggest that the ability to form necessary capital and to maintain our competitive position in world markets are two fundamental national priorities.

I commend you Mr. Chairman and members of the Banking Committee for holding these hearings. They will undoubtedly assist in the Senate's important debate over the next several months. I have only been able to highlight specific issues in my brief oral statement here today, and would appreciate the opportunity to augment my written statement with relevant background material for the official record. I would be happy at this time to answer any questions you might have.

Senator GORTON. Thank you very much.

Before we hear from you, Mr. Clark, the ranking member of the committee is here now, Senator Proxmire. Do you have an opening statement?

Senator PROXMIRE. I have no opening statement.

Senator GORTON. Mr Clark, we're delighted to hear from you. It sounds like most of what is going to be said has been said.

Mr. CLARK. No; I've got a couple of things of my own. [Laughter.]

STATEMENT OF GEORGE J. CLARK, EXECUTIVE VICE PRESIDENT, CITIBANK, N.A., ON BEHALF OF THE NATIONAL FOREIGN TRADE COUNCIL

Mr. CLARK. Mr. Chairman, members of the committee, I am George Clark, executive vice president of Citibank. I am pleased to appear today on behalf of the National Foreign Trade Council, an association of more than 500 companies engaged in all phases of international trade and investment, and to address the provisions of H.R. 3838 that primarily affect international business activities of U.S. companies.

I'm accompanied by John F. Rolph III, vice president, Citibank, and chairman of the international subcommittee of the tax committee of the National Foreign Trade Council.

EFFECTS OF H.R. 3838 ON FOREIGN LENDING

In particular, I would like to express opposition to the proposed foreign tax credit changes affecting international lending of U.S. banks, the elimination of the bad debt reserve for 2,500 banks, and the changes in the deferral of foreign-earned income.

These provisions would hurt the U.S. economy, undermine our international trade position, and jeopardize the proposed solutions to the international debt crisis, about which I will speak more shortly.

Of these proposals, Mr. Chairman, by far, the most damaging in terms of its global impact is the disallowance of the foreign tax credits on our cross-border loan transactions. The House bill would very substantially reduce the foreign tax credits that U.S. banks may now claim for gross withholding taxes paid on interest earned on cross-border loans made to foreign borrowers. We're talking here about the global debt problem.

This provision will force U.S. financial institutions which provide more than one-quarter of the cross-border loans to Third World countries to cut back on those loans, or not make them at all.

The supply of international credit will be slashed. In fact, this has already begun. A number of regional banks have recently advised U.S. Government officials that they have now stopped making cross-border loans because of the foreign tax credit changes proposed in the House bill.

Non-U.S. banks are unlikely to increase their international lending and consequently, the cost of borrowing must rise. Less developed countries [LDC], which are heavily dependent on loans from financial institutions, will suffer.

Any reduction in the supply of such funds or any increase in the price poses a real threat to their economies and, consequently, to the markets they provide for U.S. goods.

We must keep in mind that developing countries purchase some $70 billion, or one-third of U.S. merchandise exports. Cross-border loans are a key element in financing these sales. For example, two-thirds of Citibank's $900 million of private sector loans to Mexican borrowers have been made to finance purchases of U.S. goods by Mexican buyers.

GLOBAL DEBTOR PROBLEM

In addition to the impact on exports, we have to talk here today, Mr. Chairman, about the fact of the global debt problem. The international banking community today is involved in rescheduling of some $400 billion in outstanding debt of the less-developed countries.

As you know very well, because it's been covered over and over again, many banks are very reluctant to participate in these rescheduling activities, and they're looking for ways to exit the process.

H.R. 3838 will turn cross-border loans into losers or substandard earners for American banks. Banks which have been reluctant to support the efforts to reschedule and restructure LDC credits will now have an easy and valid excuse to withdraw.

Given the magnitude of the funds involved, $400 billion, and the need to keep all lenders in our rescheduling agreements, this exit opportunity could easily evolve into the global debt crisis that we have spent the last 3 years trying to avoid.

But, in addition to rescheduling present outstanding debts, the banks are now enthusiastically starting to consider new lending under the Baker initiative. Again, there are some reluctant U.S. banks who would like first to be repaid, but, instead, are going to be asked to put up new funds.

The Baker initiative may be successful if the earnings on such loans are reasonable, but H.R. 3838, as presently written, makes this impossible because of the treatment of the withholding tax.

U.S. banks are now going to say: "You are asking us to put up new money, which we don't want to do. Then you tell us we can't earn on it. Forget it."

Indeed, even Citibank, a strong supporter of the Baker initiative, would inevitably lose much of its enthusiasm because of the misdirected and negative provisions of H.R. 3838 as far as the treatment of withholding taxes is concerned.

Without the strong support of the U.S. banks, the Baker initiative is going nowhere. The point, Mr. Chairman, about the possibility of H.R. 3838 driving us toward a global debt crisis is so important and so overwhelming that if I might make the suggestion, Paul Volcker, who has worked with us so closely over the last 3 years to try to keep the crisis from developing, be asked to appear before your committee; and I think it would be very interesting to ask him to comment on what H.R. 3838 would do to his activities in helping us avoid this crisis.

I also think in the same vein that it would be very interesting to have Treasury Secretary Baker comment on what he thinks H.R. 3838 would do to the Baker initiative. The treatment of the withholding tax credit is so overwhelming that we just won't be able to participate in either activity. And I really wonder where those two gentlemen are. I certainly think they should be heard from on this subject.

I was impressed by what Senator Hecht said at the beginning that the power to tax is the power to destroy. The withholding tax treatment, in fact, Senator Hecht, destroys our ability to participate in these cross-border loans. And without the full allowance of the withholding tax, either we lose on the loans or the spread is so narrow that we would have to go on to other activities.

So, that's a very big issue that I think hasn't received sufficient treatment.

There are a number of other concerns, Mr. Chairman, that we have about H.R. 3838, which are outlined in our paper. But the question of the global debt rescheduling and the Baker initiative seemed to us so overwhelming that I think I will rest my case on the points I've made so far.

Thank you, sir.

[The complete prepared statement follows:]

STATEMENT OF GEORGE J. CLARK
EXECUTIVE VICE PRESIDENT
CITIBANK, N.A.
ON BEHALF OF THE NATIONAL FOREIGN TRADE COUNCIL
BEFORE THE
UNITED STATES SENATE COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS
HEARINGS ON
THE IMPACT OF H.R. 3838,
THE HOUSE-PASSED TAX REFORM BILL,
ON THE INTERNATIONAL COMPETITIVENESS OF
U.S. BANKS AND OTHER BUSINESSES

Tuesday, February 4, 1986

Mr. Chairman and Members of the Committee, I am George J. Clark, Executive Vice President of Citibank. I am pleased to appear today on behalf of the National Foreign Trade Council, an association of more than 500 companies engaged in all phases of international trade and investment, and to address the provisions of H.R. 3838 that primarily affect international business activities of U.S. companies. I am accompanied by John F. Rolph, III, Vice President, Citibank, and Chairman of the International Subcommittee of the Tax Committee of the NFTC. In particular, I would like to express opposition to the proposed foreign tax credit changes affecting international lending of U.S. banks, the elmination of the bad debt reserve for 2,500 banks and the changes in the deferral of foreign earned income. These provisions would hurt the U.S. economy, undermine our international trade position, and jeopardize the proposed solutions to the international debt crisis.

Of these three proposals, by far the most damaging in terms of its global impact is the disallowance of foreign tax credits on cross-border loan transactions. The House bill would very substantially reduce the foreign credits that U.S. banks may claim for gross withholding taxes paid on interest earned on cross-border loans made to foreign borrowers. This provision will force U.S. financial institutions, which provide more than one-third of international lending, either to cut back on their cross-border loans or not to make them at all. The supply of international credit will be slashed. In fact, this has already begun. A number of regional banks have recently advised government officials that they have now stopped making cross-border loans because of the foreign tax credit change in the House bill. Non-U.S. banks are unlikely to increase their international lending, and consequently, the cost of borrowing must rise. Less-developed countries, which are heavily dependent on loans from financial institutions, will suffer. Any reduction in the supply of such funds or an increase in price poses a real threat to their economies and, consequently, to the markets they provide for U.S. goods.

Developing countries purchased some $70 billion, or one-third, of U.S. merchandise exports in 1985. Cross-border loans are a key element in financing these sales. For example, two-thirds of Citibank's $900 million of private sector loans to Mexican borrowers have been made to finance purchases of U.S. goods by Mexican buyers.

Changes in the foreign tax credit provisions will impede the growth of U.S.' exports. Regional and local banks finance the small- and medium-sized companies that today are developing new products and looking for new markets. Without the current tax credit, these banks will reduce and possibly abandon this business, and their customers will find it difficult to obtain financing elsewhere. Foreign banks are not a viable alternative for these companies and, in any event, foreign banks are not likely to promote the sale of U.S. goods. In addition, a slowdown in international lending by U.S. banks will put new upward pressure on the dollar. This will further reduce the demand for U.S. exports and worsen the $148.5 billion U.S. trade deficit.

What I have been discussing so far have been the probable effects of this foreign tax credit change. Let me discuss with you the immediate and certain results of this proposal.

The international banking community today is involved in the rescheduling of $400 billion of LDC debt. Because so many banks are reluctant, it is very difficult to put the rescheduling transactions together. H.R. 3838 will turn cross-border loans into losers or substandard earners. Banks which have been reluctant to support the effort to reschedule and restructure LDC credits will now have an easy excuse to withdraw. Given the magnitude of funds involved, $400 billion, and the need to keep all lenders in our rescheduling agreement, this exit opportunity could evolve into the global debt crisis that we have spent the last three years avoiding.

In addition to rescheduling our present outstanding debt, we are now starting to consider new lending under the Baker Initiative. Again, reluctant United States banks would like first to be repaid, but instead are going to be asked to put up new funds. The Initiative may be successful if the earnings on such loans are reasonable. H.R. 3838, as presently written, makes that impossible. The U.S. banks are going to say, "You are asking us to put up new money, which we don't want to do and then you tell us we can't earn on it. Forget it." Indeed, even Citibank, a strong supporter of the Initiative, could lose its enthusiasm because of the misdirected and negative provisions of H.R. 3838. Without the strong support of the U.S. banks, the Baker Initiative is going nowhere.

Although I have emphasized the drawbacks of this foreign tax credit proposal, I would be remiss if I did not draw your attention to the significance of the proposed repeal of the tax deductible bad debt reserve method for selected banks. This is by no means limited to the money-center banks, but affects nearly 2,500 U.S. banks. Like the foreign tax credit proposal, this provision of the House tax reform package raises the cost of credit. Currently, one of the factors considered in pricing a loan is the bad debt reserve deduction available for potential losses. If the reserve method is eliminated, the after-tax cost of providing for potential losses will be substantially increased. This in turn will require an increase in loan pricing, thus making credit more expensive. This effect is not limited to international lending. Domestic borrowers in the United States and local borrowers in the foreign markets served by U.S. banks will be affected as well. Increasing the cost of credit is not in anyone's best interest.

Furthermore, this provision will require the 2,500 banks to pay taxes over the next five years on the amount of their present bad debt reserves accumulated in acordance with the tax law since 1947. These extra taxes will directly reduce their financial earnings over the five-year period, without any additional financial income, causing potential cash flow problems for banks.

The net result is that the banks' retained earnings, a component of their capital, will be significantly reduced. Less capital translates into reduced lending ability. At a time when the Federal bank regulatory agencies are trying to strengthen bank capital, and the Administration has a major policy to increase lending to the LDCs, the tax laws should not undermine these efforts.

U.S. companies which operate overseas through foreign subsidiaries, will be faced with yet another tax constraint under H.R. 3838. The proposal to eliminate tax deferral for foreign subsidiaries which earn banking, insurance, shipping and certain other types of income discriminates against companies with these types of income. Thus, the U.S. parent company will be required to pay tax currently on these earnings of its foreign subsidiaries, even though these funds are not actually repatriated. This represents a pernicious change in long-established U.S. tax policy. The consequence is that foreign subsidiaries will not have the flexibility to retain earnings, free of U.S. tax, to expand operations abroad to market U.S. goods and services. U.S.-owned service companies are already at a disadvantage because their foreign competitors benefit from subsidies and protective tariffs. The proposed change in the deferral rules will put these firms at a further disadvantage.

We are also very concerned about the impact on trade and the availability of credit of other related foreign provisions in the House bill. Specifically, we refer to the separate baskets for calculating foreign tax credits, the changes in the source of income rules, the rules requiring allocation of interest and other expenses on a consolidated group basis and the modification of the possessions tax credit under Section 936 affecting Puerto Rico.

In our view, the provisions of the House bill that I have discussed are "penny wise and pound foolish". While some believe that these major tax law changes may increase Federal revenues, we believe they will create serious long-term consequences that will jeopardize America's future economic strength. They threaten the future of U.S. exports, which presently account for 4.5 million American jobs. Of more immediate importance, they jeopardize the $400 billion LDC debt restructuring effort and the Baker Initiative to stimulate the growth and development of LDC countries.

Senator **GORTON**. Thank you very much. I think it was Mr. Huard, but it might have been Mr. Hostetler, who advised the Congress simply to start over again in connection with that, at square one. I think I would like each of you to comment briefly on that.

From your perspective, would it be possible to come up with a valid and constructive tax reform proposal?

Starting over again, but meeting all the strictures and requirements that the President has laid upon us in the respect of personal exemptions, maximum individual rates, consumption taxes, and the like, could you get from here to there even if you were able to start over again?

I would like to hear the comments of each of you on this question.

Mr. **HUARD**. I am the one that originally suggested, Senator, that you ought to start over. The answer to your question is "No."

It is possible to, I think, achieve reform which will meet the stated objectives of the President's budget, which are fairness, simplification, and economic growth. I think it is possible to do that.

H.R. 3838 WILL NOT ACHIEVE REFORM

H.R. 3838 doesn't meet those goals. It further complicates. It is deleterious to economic growth. Fairness is always in the eye of the beholder.

The problem is, while I think it is possible to design a reform bill that would meet the objectives of simplicity, fairness, and economic growth, I don't think you can do that within the strictures laid down by the President.

Basically, the President has decreed a zero sum game where you must play within the four corners of the corporate and individual income tax and it must be revenue neutral. The problem with that is that every time you fix a problem it is like pushing down one corner of a water bed. The other three corners go up.

You have this immutable tendency to create losers every time you fix a perceived problem, and obviously in order to fix the perceived need for lower rates and the $2,000 personal exemption the House bill has created 140 billion dollars' worth of losers in the corporate sector, largely in those companies that are capital intensive.

I agree with Mr. Hostetler that in order to achieve a balanced approach to reform you must go outside the four corners of the income tax and reach out to a broad-based consumption tax.

The concept that you can finance all this reform by soaking the business community is tremendously attractive politically, but it is very misleading. It ignores what I like to refer to as the Willy Sutton principle.

Willy was a legendary bank robber, and I am sure the story is apocryphal. But supposedly, he was asked by a media reporter why he robbed banks. His reply was simply because that is where the money was.

The fact of the matter is personal income in this country is well over $3 trillion, corporate income less than one-tenth of that, $280 billion. If you are going to raise revenue to finance the operations of Government, it is going to come largely from the personal sector and largely from the middle class.

That is probably politically unpalatable as a fact of life, but it is nonetheless a fact of life.

There are only two ways to get it out of the personal income sector. One is through an income tax. One is through a consumption tax.

If the President continues to hold the consumption tax off limits, then I think the answer to your question—can the reform bill be redesigned to meet all the objectives within all the limitations he set—the answer is "No."

Senator GORTON. Mr. Mack.

Mr. MACK. If you are going to set a target at which the rate for individuals and corporations is to be, and if you are then to say what you can't raise or reduce the total amount of revenue and you can't look outside the existing Tax Code to come up with new ways of raising the revenues, it doesn't take a genius to figure out that somebody's ox is going to be gored.

The House started out with the President's proposal, which, among other things, would have raised $166 billion over 5 years from removing the deduction for State and local tax deductions. It came to the conclusion that it was politically impossible to do that, and I suspect when you get all done in the Senate you are probably going to come to the same conclusion.

So, there was 166 billion dollars' worth of rate reductions that had to be paid for out of somebody else's pocket. The House then imposed, for the most part, that $166 billion tax burden on business side, in addition to the very substantial increases in business taxes that occurred as a result of the Treasury's and President Reagan's proposal.

We have made some suggestions that assume you are not going to look beyond the current Tax Code for revenue and tried to say, "Well, within these strictures here is a way to make the bill less bad than it would otherwise be."

But you can't get from here to there within the parameters the President has set forth: you have got to achieve this rate. You can't look at any new tax or any new forms of taxation, and it has got to be revenue neutral.

Senator GORTON. Mr. Hostetler.

Mr. HOSTETLER. I agree. I don't think it can be done if it is defined as the kind of rate reductions we are talking about.

NEED FOR A NEW REVENUE SOURCE

The problem is there just aren't any other sources of the size of things like the investment tax credit that I think we are all objecting to. You need a new major revenue source. The consumption tax I think is the best alternative, certainly the biggest.

Senator **Gorton**. Mr. Clark.

Mr. **Clark**. As you put it, Senator Gorton, I can be brief. The answer is "No way."

Senator **Gorton**. The three of you representing industrial concerns, or industrial groups, have all testified to a greater or lesser extent for the proposition that your competitive position vis-a-vis your international competition would be adversely impacted, and some of you at least have said that it would increase the movement of American industries overseas.

One of you can volunteer for this question. Perhaps, Mr. Huard, it is for you.

How does our current cost recovery system and investment tax credit compare with those of the most competitive of our international trading partners, and would that difference be closed or exacerbated by the passage of this bill?

Mr. **Huard**. We have a number of charts in the back of my testimony—I believe it is either appendix 2 or 3—that basically reflect the comparison of capital recovery systems with those of other industrialized nations.

Basically, what it shows is that under current law—the combination of ACRS and ITC in the most common equipment categories—we are fairly near the top or definitely in the top quartile.

Senator **Gorton**. The top quartile in the amount of tax that we impose on them or the top quarter of most favorable tax treatment?

Mr. **Huard**. Most favorable. We are more favorable than at least three-quarters of our competitors. In some cases that figure is higher.

Under H.R. 3838, in most equipment categories we would be in the bottom quartile and in a number of cases just plain dead last. That includes most manufacturing equipment, which is last. That comparison not only includes the commonly agreed industrialized countries but several semi-industrialized economies like Taiwan and Korea.

So it is pretty bleak.

Mr. **Mack**. Senator, I would agree with that. The only thing I would add is that many countries, in addition to what is in their tax code, will by regulation, some of it published, much of it not, favor specific industries in order to improve their export competitiveness.

So, to look simply at the tax code of other countries is sometimes deceptive, in the sense that you are not getting the whole picture.

I would agree with what he said except maybe I would move us, given these special rules I mentioned maybe down a peg under both current law and certainly under H.R. 3838.

Mr. **Hostetler**. I can't speak from the viewpoint of an international tax expert, but I do know the kind of incentives we have as a company to invest money overseas as opposed to the United States, and the electronics industry and our company has not been traditionally a high-capital investment business.

But that is changing very, very rapidly, and for us to keep up and provide leadership in electronics, which I think is crucial to all the rest of the industries we are talking about, we have to put in a much more massive investment in the future than we have in the past.

And there are a lot of incentives for us to make that investment overseas as opposed to the United States, and the current combination of investment tax credit and depreciation approaches give us the opportunity to make investments in the United States that we might otherwise have to make overseas to justify the returns.

Senator **Gorton**. Thank you.

Senator Proxmire.

Senator **Proxmire**. Thank you very much, Mr. Chairman.

Mr. Mack, I agree with you gentlemen to a considerable extent. I certainly feel that we ought to repeal the corporate tax, flatly repeal it. But we are not going to repeal it. We can't get along without the revenue.

So, I think we ought to make it fair. I can't understand for the life of me how anybody can defend a system which for the years 1981-84 shows 65 corporations had net profits of $49 billion during that period and paid nothing in taxes in any year.

Now, one of the reasons we have that is because we have the investment tax credit, because we have accelerated depreciation. We have special accounting, allowances for defense contractors, and so forth.

MINIMUM TAX ON CORPORATIONS

How about a minimum tax? If we can't get rid of the corporation income tax—I know you people want something else, but we can't get rid of it—why not just have a minimum tax on all corporations so that the corporations all pay something like the same?

Now, 46 percent for the corporation income tax after the first $100,000. That 46 percent, as I say, is ridiculously administered. The average big bank like Citibank pays about 2 percent. Many industries, many of their principal corporations pay nothing at all.

Why not have a minimum tax so that all corporations pay the same on their net income?

Mr. **Mack**. Senator, first of all, I must say that the measurement against the 46-percent rate, or whatever rate you are using, is the definition of what constitutes taxable income. Also, as you point out, the investment tax credit, is intended to and, in fact, does is relieve taxes on equipment purchased to try to improve the competitive position of the company and therefore of the country.

But conceptually I guess I have got a problem with the minimum tax. In effect what you are doing is saying, "Well, we are going to provide these incentives—we are going to provide these provisions in the Tax Code—but if you use them too much then we are going to take them back."

Again, in the interest of fairness maybe that should be done. The problem, it seems to me, is that if what the objective is, is to get everybody to pay some tax or to pay their fair share, then, who is everybody?

For example, does everybody include someone who honest to God loses money? Should they pay tax on income they didn't earn?

Some of the minimum tax proposals that have been going around do that. If you have a minimum tax rate that is too close to the regular tax rate, then you have people who, as we suggest in our testimony, will postpone, defer, or not make at all investments simply to be sure that they don't get into a minimum tax position.

It seems to me that you have got to have a greater spread between the rates of taxation under the regular tax and the minimum tax.

Third, if one is truly interested in competitiveness, which I know everybody around this table is, it seems to me difficult to justify including in the base of items that you add back in to get to the preferences for purposes of the minimum tax—things like depreciation and other investment people make to try to get more competitive, such as R&D.

Thankfully, the House didn't include R&D as a preference. It is impossible to include R&D as a preference if you are trying to approximate book income, because there isn't an accounting firm in the world that will permit any of our members to do anything other than expense R&D for book purposes.

As a matter of fact, if you included R&D I suspect you would find that even our very smallest members—none of whom, as you know, Senator, have been making money for the last 3 or 4 years—all of a sudden are thrust into a minimum tax position, paying taxes on money they didn't earn.

I don't know that I have been entirely adequate in answering your question. What I have tried to do is to point out that it is extraordinarily difficult to come up with a minimum tax that is fair and which does not lead to economic results that I am sure none of its proponents intended.

Senator **Proxmire**. By and large, overall, isn't it true that a corporation income tax is paid by the people who buy what the corporation sells, provided you have ease of entry, provided you have competition?

The corporations are inanimate objects. They can't pay the tax. People pay taxes, all the taxes.

So, it is either the people who buy what the corporation sells or the stockholders or the employees. That is it. And to the extent, as I say, that you have effective competition, it seems to me it is the people who buy.

So, you have got a consumption tax in a sense, a very rough, crude, inequitable, unfair consumption tax in the corporation income tax, and it is unfair because we apply different amounts to different industries.

Let me ask Mr. Clark. Mr. Clark, it is a public record, so how much did Citibank pay the Federal Government in taxes last year?

Mr. **Clark**. Senator Proxmire, in 1984 Citibank paid $28 million in current U.S. taxes and deferred U.S. tax of $45 million. That is a total of $73 million in U.S. taxes.

You have to keep in mind that we have substantial overseas earnings, and we basically pay substantial taxes in the foreign countries where we operate.

[The following information was subsequently submitted for the record by George Clark:]

CITIBANK. N.A.,
New York, NY, February 12, 1986.

HON. WILLIAM PROXMIRE,
U.S. Senate, Room 530, Senate Dirksen Office Building, Washington, DC.

DEAR SENATOR PROXMIRE: In connection with my testimony before the Senate Banking Committee on February 4, 1986, I would like to expand on my response to your question about the amount of taxes paid by Citicorp in 1985.

Under the current U.S. tax law, the U.S. imposes a 46-percent corporate income tax on the worldwide income of U.S. multinational corporations, i.e., the U.S. taxes both the domestic and foreign income of such corporations. In order to avoid double taxation of the same income the U.S. allows foreign tax credits, not to exceed 46 percent, for foreign income taxes paid by a U.S. company on its foreign earnings.

It is to be emphasized that all countries with which the U.S. competes in the international market place have foreign tax credit systems similar to, and in many cases more liberal than, the U.S. foreign tax credit system for income earned abroad. A U.S. company such as Citicorp, which has substantial foreign earnings, will pay substantial foreign taxes and, as noted, is entitled to claim U.S. foreign tax credits (to offset its U.S. tax on its worldwide income) for taxes paid to foreign countries on income earned in such countries, in order to avoid double taxation of its foreign income.

Attached is an excerpt from the 1984 Annual Report, which analyzes the corporation's income tax figures. In 1984, Citicorp reported to its shareholders net-after-tax income of $890 million. Citicorp's total tax provisions for income taxes was $654 million, of which $28 million was current Federal taxes, $45 million was deferred Federal tax and $540 million was foreign taxes (substantially all current). Although Citicorp's current Federal income taxes may seem low when compared to its worldwide earnings, Citicorp's total worldwide tax is a very substantial portion of its total worldwide income. While the 1985 Annual Report has not yet been published, Citicorp's provisions for income taxes (worldwide) in 1985 was $718 million as compared to income before taxes of $1,716 billion.

You may also be interested in reviewing our analysis of the Citicorp effective tax rate as shown in the excerpt from our 1984 Annual Report. It shows an effective tax rate in 1984 of 42.4 percent on worldwide income. This figure does not incorporate the de facto additional tax of approximately $59 million arising from the non-interest bearing reserves that Citibank is required to maintain with the Federal Reserve System.

I hope this information is useful to you in clarifying the record on this point.

I respectfully request that this letter be submitted as part of the record of the hearings before the Banking Committee on February 4, 1986.

Sincerely,

GEORGE J. CLARK,
Executive Vice President.

Attachment.

BANKS PAY BETWEEN 2 OR 3 PERCENT NET IN TAXES

Senator **PROXMIRE**. Shouldn't you pay taxes to the Federal Government, that makes all kinds of advantages for you? Here, you had a corporation that earned almost $1 billion last year. But, instead of paying $450 million in taxes, you paid less than one-tenth of that to the Federal Government.

It's nice that you pay taxes to the United Kingdom, Germany, and Japan. I'm sure they're happy about that. But, the Federal Government, it seems to me, should be in a position of collecting more than 3 percent, which is about what your corporation paid in taxes.

Is that right?

Mr. Clark. You know, the way the world works today, Senator Proxmire, a great deal of our business is dollar lending across borders. And a great deal of business is local business in the local countries abroad.

The way it works is that we claim a foreign tax credit for the heavy taxes abroad. That's where most of our tax is paid.

Senator Proxmire. And Citibank isn't exceptional. You have all kinds of other banks that don't do much abroad and also pay about 2 or 3 percent. The biggest banks in this country pay around what you pay—about 2 or 3 percent of their net profits in taxes to the Federal Government, whether they're are as heavy in investment abroad as you are or not. Isn't that right?

Mr. Clark. Our situation is different, Senator Proxmire, because so much of our business is abroad. But, of course, you're correct that some banks that operate domestically in the United States, which don't get involved in the foreign tax credit, also don't pay large taxes.

But it's not for me really to speak for them. The banks are required to maintain a lot of liquidity-type reserves. For example, we have reserves at the Federal Reserve. The Federal Reserve earns $16 billion a year on the liquidity reserves that the banks hold there, which, as you know, is a kind of a tax on the banks to maintain their liquidity.

I think it is an appropriate one, but it is a cost of business—$16 billion a year flows through the Fed to the Federal Treasury from our reserve deposits, which don't get counted at all in the tax figures that you're talking about.

There is another thing that banks do for liquidity purposes. Many of them invest heavily in local securities which are tax free because, the American public, in its wisdom, has decided that it's good for banks to invest in those securities.

So, you have to take those into consideration. It's a special kind of business in that sense.

Senator Proxmire. Mr. Clark, when I was in the Wisconsin Legislature in 1951, all corporations and individuals had to make public their income tax payments.

So, I took the five biggest banks in the State of Wisconsin, and there are some pretty big ones, and I found that in the preceding 5 years they had paid a total to the Federal Government of $75—not $75 million. It was $75 in taxes.

I found that some States imposed a franchise tax on banks instead of an income tax because an income tax doesn't yield anything.

So, it seems to me that, one way or another, we have to take a broader look. And I think you gentlemen deserve commendation for suggesting that we consider—maybe not a consumption tax, but some kind of a tax that is broader than what we have now.

My time is up but what bothers me most about your presentation is that I would like to hear something from you from the standpoint of justice and equity. It seems to me we ought to have a progressive tax system.

In other words, it's not fair to tax people who have incomes of $10,000 or $15,000 on the same basis as you would somebody who has an income of $200,000. With a consumption tax, you tend to do that. You don't with an income tax, but with a consumption tax, you do, unless you have a consumption tax which is, to some extent, progressive.

So it would be interesting if you could make that kind of statement.

Mr. MACK. Senator, I don't disagree with you if what we were doing was to replace the entire tax structure that we have now with a consumption tax. Our association is looking very carefully at Senator Roth's proposal and some of the others, I would agree with you if, as I said, you were just going to go to a consumption tax. But it seems to me that what you want to have is a combination of taxes, be they consumption, income, FICA—payroll taxes—which are highly regressive—that in total provide fairness and the kind of progressivity that you're looking for.

I think the case could be made that we don't have such a system today.

Senator GORTON. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman. I will have a lot of questions on this but until such time as we know what we're looking at and what we're going to talk about, Senator Gorton, as you know, last week, we were at the White House and the President said: "If the House tax bill comes to me the way it came over to the Senate, I'm going to veto it."

So I'd like to know exactly what we're looking at before we start asking questions. And each one of you, I enjoyed your remarks and will come back to you.

A couple of points I want to bring up with Senator Proxmire, when he said I think 49 corporations in the $1 billion class pay no taxes——

Senator PROXMIRE. No, 65.

9 MILLION NEW JOBS IN AMERICA

Senator HECHT. Well, 65; I think that's fine. Let's look at the end result. There's 9 million new jobs in America today in the private sector since the President took office. There's 100,000 less in the Government.. So there's only one way they could avoid paying taxes—to reinvest, expand plant capacity, and spend money on research.

Senator PROXMIRE. Would the Senator yield?

Senator HECHT. Of course.

Senator PROXMIRE. I think that's fine. What I object to is the fact that some corporations can do this and others don't. Some have to pay a much higher rate. So if you can do that, let's abolish all corporation income taxes. That was my suggestion.

Senator HECHT. Taxes are for anyone, anyone who wants to go out and expand and buy property and depreciate, tax-accelerated depreciation, it's available to anyone. I've done this in the private sector, before I came here. This is not just for a few select banks.

One other point I want to bring up. The 14,500, roughly, commercial banks in America today, I think you're going to find that most of those banks, probably 95 percent of them, are paying the top corporate rate.

In other words, a lot of banks want to expand new computers, new technology, and they can go on. But the tax law for banks—I was involved in a bank. We paid the top corporate rate.

The fact that a bank has reserves, the very people that might be up here criticizing the reserves, but every time there's a bank failure, there's not enough reserves. So you've got to look at it rationally from both sides.

Anyway, when we get this tax bill, I want to ask your opinion on them because, as of today, we don't have anything we can start accepting.

That's all, Mr. Chairman.

Senator **Gorton**. Thank you. Senator Sasser.

Senator **Sasser**. Thank you, Mr. Chairman.

Mr. Mack, I was struck by an estimate that you referred to in your testimony—at least, I read it in your testimony. And I apologize. I didn't get here in time to hear your entire testimony.

But in the testimony, you say that preliminary estimates indicate that the technology involved in over 75 percent of the machine tools being sold today did not exist 5 years ago. Seventy-five percent of the technology in machine tools being sold today did not exist 5 years ago.

Mr. **Mack**. That's correct.

Senator **Sasser**. My question to you is how much of that 75 percent of machine tool technology was developed here in the United States by American machine tool manufacturers, or by American engineers?

Do you know?

Mr. **Mack**. Most of it. What the 75-percent figure refers to is that we asked our members not what are you showing in your catalogs, but what are people actually buying out there? How much of that technology was available 5 years ago?

Now, 75 percent of that technology was not available 5 years ago. The machine may look the same, but the technology is different. And most of that was developed in the United States.

Senator **Sasser**. You can't give us a precise figure though?

Mr. **Mack**. I'll try to see if I can.

Senator **Sasser**. Perhaps you can just——

Mr. **Mack**. Let me see if I can provide something for the record.

FAIR SHARE FROM NEW TECHNOLOGY

Senator **Sasser**. Rather than hold up here, perhaps you could just provide it for the record. I'm interested in this whole question of whether or not we're doing as much as we can, to ensure getting our fair share of the markets evolving out of new technology.

[The following information was submitted for the record:]

A Statement Concerning Recent Advances in the Technology of U.S.-Built Machine Tools

Technology, products, processes or features that were not in widespread commercial use 5 years ago, but which are included in or incorporated into U.S. built machine tools being sold today are listed below. The list contains examples of advances made principally or initially as a result of the research and development efforts of companies within the United States.

a. Control equipment incorporating advanced microprocessor chips and other special semiconductor devices.

b. Non-contact, in-process inspection and gaging equipment.

c. Cathode ray tube (CRT) displays for status reporting and for part programming assistance.

d. Advanced communications interfaces and associated software programs to allow the interconnection of multiple workstations and a multiplicity of processes.

e. Voice recognition and speech synthesis hardware and software to make more efficient the man-machine interface.

f. Cutting tool materials such as the Cubic Boron Nitride (CBN), Polycrystalline Diamond Compound (Compax), and coated carbide inserts, for more efficient metal removal.

g. Increased metal cutting chip loads and increased cutting speeds resulting from the new, advanced cutting tool materials.

h. Composite lay-up machines, large multi-axes NC controlled skin-mills, complex multi-axes profilers, etc.

i. Self-diagnostic systems, which are especially useful on large automotive type transfer machines.

j. Powerful programmable controllers (PC's) for use on transfer machines and storage and retrieval systems.

k. Sophisticated computer controlled inspection systems such as coordinate measuring machines (CMM) and automated inspection systems.

l. Computer-aided design and computer-aided manufacturing (CAD/CAM).

m. Integrated industrial automation systems which include one or more of the following: automatic part storage and retrieval systems, automatic inspection systems, tool management systems, computerized accounting, CAD-CAM, etc.

Senator **Sasser**. I want to read an excerpt from a report issued by the Organization for Economic Cooperation & Development, 5 years ago.

Of course, that 5 years ago was before the 75 percent of the machine tool technology was developed, but I'd like to get your reaction and that of the rest of the panel.

From this report:

> There is now a large measure of agreement that the stimulation of industrial innovation should be a major element in current strategies. In the majority of member countries, the promotion of innovation is seen as a priority in coping with the present economic crisis.

This was in 1979. In October 1979, the President of the United States devoted a Presidential message to this theme, in which he pointed out that the development and commercialization of new products and processes, "helps ensure economic vitality, improved productivity, international competitiveness, job creation and improve quality of life." So said the President in 1979.

In Japan, the Planning Bureau of the Science and Technology Institute has estimated that the contribution of technological progress to national economic growth was 40 percent in 1950, the 5-year period from 1955–60, growing to a percentage between 1975–82 of 65 percent per year.

That is, technological progress from between 1975–82 in Japan amounted to 65 percent of the economic growth in that country in that 7-year period. Some in new products, some in new developments, some in new processes.

Do we have the capacity in the United States for that kind of growth based on industrial organization, or have we missed out on this revolution?

I'd ask you that question, Mr. Mack.

Mr. **Mack**. I don't think we've missed out. I think that if you pass H.R. 3838, that it will encourage people to take the technology that they've developed in the United States offshore and manufacture the product resulting from that innovation in some place other than the United States; because the cost of capital for producing that product will be substantially higher here than elsewhere.

If I can manufacture something somewhere else, bring it into the United States, sell it in the United States and pay a lower rate of tax than I am today on that transaction, it doesn't take a genius to figure out that that's exactly what I'm going to do.

So we would assert that this bill in its present form will result in higher imports and more shipment of technology offshore. Now, the more the incentive to make things offshore, the less the technology is going to be developed in the United States, and the less competitive the companies become down the line.

If, for example, we become foreign-source-dependent for machine tools, then the automobile industry—that new Saturn plant in your State, or in Michigan—the automobile industry or other major users of machine tool technology are going to be waiting until the people who produce the machine tools in Japan or wherever first give—to their own automobile industry, the results of that technology. Maybe 2 or 3 years later, they send these really highly sophisticated machines to the United States.

So it then feeds on itself. If you're interested in improving technology development and innovation and making sure that the products developed from that innovation are produced in the United States by U.S. workers, the thing not to do is to pass the bill as it came over from the House.

Senator SASSER. Does anybody else want to respond to that?

Mr. HOSTETLER. Yes, Senator, if I may. I think there was, in fact, a period, speaking for our own industry, there was in fact a period where the rate of technological progress was not as great in the United States as it was, for instance, in Japan.

As a result of that, we've completely lost some industries. I've mentioned in my testimony the consumer electronics industry from the United States. We have had to completely reorient our own company to focus on other industries.

Today, I think that the rate of technological progress in the United States, particularly in electronics, is at least at the rate of our competitors in the world market, and we are being aided by the R&D tax credit and the investment tax credit, and so on.

The thing we've got to do is make sure that we keep that rate of progress at at least the rate of our competitors and that we don't do things in the Tax Code that discourage that.

Senator SASSER. I think I've served up one to everybody and not gotten one out of the ballpark yet. [Laughter.] But my time is up.

Senator GORTON. Senator Riegle, it's your turn and happy birthday. [Laughter.]

Senator RIEGLE. Thank you, Mr. Chairman. And let me also thank you for conducting these hearings, which I think are very important. I just hope we can get some attention to the views being expressed here because I think it's important that they are widely shared throughout the Senate when we take up tax reform.

I support the President's effort to try to reform the tax laws. It's a lot easier to say it than do it, as we all know. But let me ask, as I'm very much of a mind to agree with much of what I heard today, but I'm concerned about the proposed changes on the business side that I think will hurt the cost of capital and will hurt our ability to improve productivity faster, create jobs, and stay in the technological race with other countries.

So I think these are critically important, and yet, at the same time, subtle questions. It's important to try to understand what is happening here.

LOOKING AT THE 1981 BILL

My first question would be this: Are any of you able to document convincingly significant gains that we have achieved because of the tax incentives incorporated in the 1981 tax bill?

I voted for that at the time because I thought the change in depreciation lives, and the investment tax credit and the research and development investment tax credit were very much needed at the time.

But there's been a lot of assessment both ways as to whether or not it's meant much or not meant much in the intervening time. And now we're down to in effect a repeal of everything we put in place in 1981.

One of the ways we can test the merit of that is to try to pin down exactly what we got for those changes. What, in the way of either improved competitiveness, or to speed up the technological change, or jobs, or national wealth or income, do any of you feel we have achieved on the margin from putting those tax incentives back in the law back in 1981?

Who would like to go first?

Mr. **Huard**. I'll be glad to submit some citations and econometric analyses for the record. I don't have them in my testimony. A number of studies have been done by respected economists in this field. My recollection is that one of the more prominent ones—I think it might have been done by Allen Sinai, I'm not sure—but it shows that capital investment over the period 1981 through 1985 was 2 percent higher than it would have been. Two percentage points, not just 2 percent, total than it would have been absent those provisions.

Now, there were several years in that timespan, 1981, 1982, where the capital investment figure was pretty dismal but that's because we were in the midst of a large recession and a lot of manufacturers were running 60 to 70 percent capacity. And that's not a normal time to build new plant and equipment.

So it's a relative thing. There are studies which show that the capital investment picture, which obviously relates to jobs, was better than it would have been without the 1981 act.

Senator **Riegle**. It seems to me, if I may just say, if we're going to save any of those things currently in the Tax Code, we're going to do it on the strength of improvement that they paid off. We can't just be impressionistic.

Mr. **Huard**. I will submit these for the record.

[The following study was subsequently submitted for the record:]

"Tax Reform" and the U.S. Business Sector

by Allen Sinai*

Chief Economist and Managing Director
Shearson Lehman Brothers, Inc.
New York, New York

Just a scant four years after the enactment of legislation to enhance the tax incentives for business capital formation, the Reagan Administration has proposed major changes in business taxation that will significantly curtail business capital spending and liquidity.

In a major turnabout, the new Reagan tax proposals would remove much of the subsidies to business capital formation and business saving that were motivated by an apparent national goal to increase savings and capital formation. Table 1 summarizes the Reagan proposals as they pertain to the business sector.

The tax changes amount to an estimated tax increase for business of $19 billion to $26 billion per year over the next five years, $118.7 billion in total, or 24.4%, on average, per year.[1] Of the various changes in taxation, those which most affect capital spending: elimination of the investment tax credit (ITC), limitations on accelerated depreciation in the early years of investment, reductions in corporate profits taxes, the "recapture" of windfall gains from prior accelerated depreciation, and a 10% deduction for dividends paid comprise 49.1% to 73.2% of the total. The "recapture" of windfall tax savings, which totals $56.5 billion over four years, wipes out one-third of the reductions in corporate profits taxes. The increase in taxes from removing the ITC and limiting accelerated depreciation exceeds the net reduction in profits taxes (reduced corporate profits taxes less the increased tax on windfall gains) by $68.5 billion over the next five years.

By contrast, the Economic Recovery Tax Act (ERTA) of 1981 reduced business taxes by $147.3 billion over the subsequent six years. Even after the $42.2 billion of tax increases for business legislated from 1983 to 1985 in the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, the net reductions in taxes that affected business capital formation still totaled $1.6 billion in 1981, $9.6 billion in 1982, $15.2 billion in 1983, $22.1 billion in 1984, and $28.6 billion in 1985 for a total of $77.1 billion from 1981 to 1985. TEFRA and the Deficit Reduction Act of 1984 (DEFRA) raised business taxes in 1986 and 1987, by $31 billion to $37 billion and $43.5 billion to $51.9 billion, respectively. These tax increases now will be essentially cancelled if the new tax proposals are enacted into law. Tables 2, 3, and 4 summarize the tax reductions and changes of ERTA, TEFRA and DEFRA with respect to actions that impact on business. Table 5 compares the current proposals for the tax system with the pre-1981 law.

Table 1
"Tax Reform" and the Business Sector

Measure	Enactment Date	Phase-in or Retroactive Provision(s)	Tax Revenue Impacts (Billions of Dollars)					
			1986	1987	1988	1989	1990	Total
1. Remove ITC	1/1/86	prior outlays, use prior rules	14.0	25.6	29.4	33.3	37.4	139.7
2. CCRS not ACRS	1/1/86	same	0.3	-0.7	2.3	8.7	15.4	26.0
3. Indexing inventories	1/1/87	none	--	-2.4	-4.5	-4.5	-4.5	-15.9
4. Corp. profits tax (46% to 33%: revised grad. rate struc., corp. min. tax)	7/1/86	none	-10.0	-26.7	-35.9	-39.0	-41.8	-153.4
5. 10% div. deduc.	1/1/87	none	--	-3.4	-6.2	-7.2	-8.0	-24.8
6. "Recapture" windfall from accel. deprec.	1986-88	12% of income inclusion, 1986; 12% in 1987; 16% in 1988	7.6	19.4	20.4	9.1	--	56.5
7. Income measurement	1/1/86	old rules prior, 10-year	3.3	6.9	10.3	13.6	15.0	49.1
8. Subsidies--elimination								
a. energy	1/1/86	old rules prior	--	0.1	0.2	0.4	0.7	1.4
b. finan. instits.	1/1/86	old rules prior	2.1	4.2	4.9	5.7	6.9	23.8
9. Repeal exemptions for state and local govt. bonds	1/1/86	some transition	--	-0.3	-0.6	-0.8	-1.0	-2.7
10. Business expenses	1/1/86	none	0.3	0.6	0.8	0.8	1.0	3.5
11. Spec. expensing and amortization	1/1/86		0.4	0.3	0.1	0.1	0.1	1.0
12. Other subsidies	1/1/86	over 3 years	-0.3	-0.9	-1.0	-1.1	-1.2	-4.5
13. International	1/1/86	none	1.3	3.4	4.1	4.6	5.1	18.5
14. Tax shelters	1/1/86	none	-0.1	-0.2	-0.3	-0.3	-0.4	-1.2
15. Other-expensing first $5,000 of deprec. prop.	1/1/86	sched. increase dropped	--	--	0.2	0.3	0.4	0.9
Total			18.9	26.1	24.3	23.9	25.2	118.7
Percent of Baseline Revenues			24.6	28.9	24.2	22.5	22.7	24.4

Source: Department of Treasury and The White House, The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity, May 1985.

Table 2
Economic Recovery Tax Act (ERTA):
Provisions and Losses in Tax Receipts
(Unified budget, billions of dollars, fiscal years)

	1981	1982	1983	1984	1985	1986	Total
Total	1.6	37.7	92.7	149.9	199.3	267.6	748.8
Personal:	*	26.7	74.8	121.8	158.1	209.9	591.3
Rate Cuts		25.8	65.7	104.5	122.7	143.8	462.5
Other	*	0.9	9.1	17.3	35.5	66.0	128.8
Corporate:	1.6	9.6	16.7	26.7	38.6	54.1	147.3
Accelerated Capital Recovery System	1.5	9.6	16.8	26.3	37.3	52.8	144.3
Other	0.1	*	-0.1	0.4	1.4	1.3	3.1
Excise		1.3	1.3	1.5	2.5	3.6	10.2
Total - Personal	*	26.7	74.8	121.8	158.1	209.9	591.3
Rate Cuts		25.8	65.7	104.5	122.7	143.8	462.5
Indexing					12.9	35.8	48.7
Marriage Penalty		0.4	4.4	9.1	11.0	12.6	15.5
Estate and Gift		0.2	2.1	3.2	4.2	5.6	15.3
15% Net Interest Exclusion					1.1	3.1	4.2
Retirement Plans		0.3	1.5	2.0	2.5	2.8	9.1
Charitable Deductions		*	0.2	0.2	0.7	2.7	3.8
Employee Stock Onwership Plans			0.1	0.6	1.7	2.2	4.6
Foreign Earned income		0.3	0.5	0.6	0.6	0.7	2.7
All Savers Certificates		0.4	1.8	1.1			3.3
Other	*	-0.7	-1.5	0.5	0.7	0.6	-0.4

*Less than $50 million
*Source: U. S. Congress, Joint Committee on Taxation, August 5, 1981.

Table 3
Tax Equity and Fiscal
Responsibility Act (TEFRA):
Provisions and Gains in Tax Receipts
(Unified budget, billions of dollars, fiscal years)

						Total	
	1983	1984	1985	1986	1987	1983-85	1983-87
Personal	5.9	15.2	15.0	15.8	16.4	36.1	68.3
Compliance and Enforcement	3.4	8.9	8.7	10.2	11.2	31.0	63.4
Withholding of Interest and Dividends	1.3	5.2	4.0	4.6	5.2	10.5	9.8
Other	2.0	3.6	4.7	5.6	6.0	10.3	21.9
IRS Enforcement	2.1	2.4	2.4	1.3	0.6	6.9	1.9
Alternative Minimum Tax	--	0.7	0.7	0.7	0.7	1.4	2.0
10% Minimum Medical and Casualty Deduction Floor	0.3	2.5	2.4	2.6	2.8	5.2	10.6
Other	0.2	0.8	0.9	1.0	1.1	1.9	4.0
Corporate	7.4	15.4	19.4	31.0	43.5	42.2	116.7
Modifications to Safe Harbor Leasing	1.0	2.6	4.3	5.5	7.0	7.9	20.4
ACRS Changes	--	--	1.5	9.9	18.4	1.5	29.8
Investment Tax Credit	0.5	1.6	2.9	4.3	5.7	5.0	15.0
Alternative Minimum Tax	0.5	0.9	0.9	0.9	1.0	2.3	4.2
Tax Exempt Bonds	0.1	0.3	0.5	0.7	1.1	0.9	2.7
Accelerated Payments	1.0	3.0	0.8	0.8	0.5	4.8	6.1
Completed Contract Accounting	0.9	2.2	2.5	2.4	2.6	5.6	10.6
Insurance Provisions	1.9	2.2	2.9	3.1	3.4	7.0	13.5
Other	1.5	2.6	3.1	3.4	3.8	7.2	14.4
Excise	2.8	4.0	4.7	2.1	1.5	11.5	15.1
Cigarette	1.3	1.8	1.9	--	--	5.0	5.0
Telephone	0.6	1.1	1.6	0.7	--	3.3	4.0
Airport and Airway	0.8	1.0	1.1	1.2	1.4	2.9	5.5
Other	0.1	0.1	0.1	0.2	0.1	0.3	0.6
Social Insurance Contributions	1.9	3.1	3.6	2.9	2.6	8.6	14.0
Unemployment Tax	1.4	2.4	2.7	1.9	1.5	6.5	9.9
Other	0.5	0.7	0.9	1.0	1.1	3.1	5.2
Total	18.0	37.7	42.7	51.8	63.9	98.4	214.1
Addendum: Spending Offsets From User Fees	1.1	1.4	1.7	--	--	4.2	4.2

Source: U.S. Congress, Joint Committee on Taxation, August 24, 1982 and Senate Budget Committee, June 23, 1982.

Table 4
The Deficit Reduction Act of 1984 (DEFRA): Provisions and Gains in Tax Receipts
(Unified Budget, Billions of Dollars, Fiscal Years)

	1984	1985	1986	1987	1988	1989	Total
Total	1.1	10.6	16.9	22.8	25.5	27.4	104.3
Personal	0.6	6.7	9.0	11.0	13.7	15.8	56.8
Net Interest Exclusion		1.0	2.9	3.1	3.4	3.6	14.0
Income Averaging	0.1	2.0	1.9	2.1	2.2	2.4	10.7
Interest Income on Deferred Payment Transactions		0.2	0.7	1.1	1.7	2.3	6.0
All Other	0.5	3.5	3.5	4.7	6.4	7.5	26.1
Corporate	0.7	3.5	6.0	8.4	9.9	10.8	39.3
ACRS	0.5	1.6	3.5	5.9	8.5	10.6	30.6
Tax-Exempt Entity Leasing	0.3	0.8	1.6	2.8	4.7	6.7	16.9
Accelerated Depreciation	0.1	0.3	0.8	1.5	2.2	3.0	7.9
Safe-Harbor Leasing	0.1	0.4	0.9	1.4	1.4	0.7	4.9
Recapture		0.1	0.2	0.2	0.2	0.2	0.9
All Other	0.2	1.9	2.5	2.5	1.4	0.2	8.7
Excise	-0.2	0.5	2.0	3.3	1.9	0.8	8.3

Source: U.S. Congress, Joint Committee on Taxation, December 31, 1984, and November 26, 1984.

Table 5
Effects of Tax Reform
(Unified Budget, Billions of Dollars, Fiscal Years)

		1986	1987	1988
Accelerated Depreciation				
Pre-ERTA:	Effective Life of Equipment (Years)	11.1	11.1	11.1
	Effective Life of Structures (Years)	22.8	22.8	22.8
Tax Reform:	Effective Life of Equipment (Years)	6.0	6.0	6.0
	Effective Life of Structures (Years)	19.1	19.1	19.1
Net Tax Change (including recapture)		-13.9	+0.4	-7.5
Investment Tax Credit				
Pre-ERTA (Percent)		8.6	8.6	8.6
Tax Reform (Percent)		0	0	0
Net Tax Change		14.0	25.6	29.4
Statutory Tax Rate				
Pre-ERTA (Percent)		46	46	46
Tax Reform (Percent)		39	33	33
Net Tax Change (Including Inventory Indexing)		-10.0	-29.1	-40.4
Total: Net Tax Change		-9.9	-3.1	-7.5

Sources: U.S. Treasury, Office of Tax Analysis, The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity, May 1985;
U.S. Office of Management and Budget, Budget of the U.S. Government, Fiscal Year 1986, February 1985; and
U.S. Congress, Joint Committee on Taxation, December 31, 1984, August 24, 1982, and August 5, 1981.

What are the impacts of these measures on business capital formation and liquidity? Fundamentally, there is no way that business taxes can be raised without reducing business spending. Removing much of the targeted tax subsidies for business capital formation and substituting a nontargeted and lesser amount of corporate profits tax reductions should reduce output, lower business equipment and plant outlays, lessen the associated borrowing, depress employment, reduce wages, and cut aftertax corporate profits in the most capital-intensive sectors and industries of the U.S. economy. On the other hand, output, employment and aftertax profits should rise in the most labor-intensive sectors and industries. Overall, the net increase in business taxes means less production, less capital spending, less employment, and lower profits for the business sector than otherwise would be the case. The shrinkage in business sector activity, especially in goods-producing industries, will result in less productive capacity and potential output for goods production and more inflationary pressure on product prices as the U.S. economy continues to grow.

Certainly, there is implicitly a major retreat from the avowed goal of increased business capital formation, so much a part of the original Reaganomics programs of early 1981.[2] Removing or limiting the targeted subsidies to business capital spending and saving compared with current law must necessarily reduce spending for equipment and plant and limit cash flow. If raising the proportion of aggregate national output devoted to business capital formation is a goal of national economic policy, using tax subsidies to help do so can be desirable and efficient, despite introducing distortions and allocative inefficiencies compared with a system where increased business capital formation is not a goal. In the latter situation, removing existing tax subsidies for business capital formation should increase the efficiency of the system.[3]

This study makes no judgment on whether the tax incentives for business capital spending are "good" or "bad." Such a judgment can only be made in the context of stated goals on capital formation. Rather, the analysis is concerned with the impacts of major business taxes such as investment tax credits, accelerated depreciation, and corporate profits taxes on capital spending and business saving. Of particular interest is the relative impacts of the three different types of business taxes on capital spending compared to the changes in revenues brought about by each tax--the so-called "bang-for-a-buck" of a change in taxes.

The study reviews some evidence on the impacts of various tax measures that affect business capital formation and liquidity; examines the impacts of the ERTA, TEFRA and DEFRA changes in business taxes on business capital spending from 1981 to 1985; and assesses the impacts of the new proposals for "tax reform" on business capital formation over the next few years. There is a discussion of previous work on tax incentives and business capital formation, concentrating on the relative impacts of the ITC, accelerated depreciation, and corporate profits taxes; quantitative analyses of the effects from ERTA, TEFRA and DEFRA based on new partial equilibrium models of business capital spending developed at Shearson Lehman Brothers and within the context of a complete model of the U.S. economy, also developed at Shearson Lehman Brothers; and an assessment of the new tax reform proposals.

Tax Incentives, Corporate Profits Taxes, and Impacts on Business Capital Formation: A Review of Some Evidence

The literature and research on the impacts of business tax incentives and corporate profits taxes on business capital spending and liquidity are voluminous.[4] Most work stems from the early 1960s research of D.W. Jorgenson and various collaborators, where a framework based on neoclassical theory was developed that permitted the analysis of tax effects on desired capital stock and business capital outlays. Though highly controversial, mainly because of a potential upward bias in the response coefficients for tax effects stemming from a multiplicative variable combining of relative prices and output, the Jorgensonian framework has been the basis of most work on taxes and investment behavior for the last 20 years.[5]

The most important determinant of business capital outlays is generally agreed to be the pace of sales growth, or demand, relative to existing capacity utilization.[6] Increased sales, if sustained or expected to be "permanent," must be met with increased equipment or plant in order for firms to supply goods to buyers. The tighter is capacity the more rapid the pace of capital outlays must be and the greater is the rate of capital spending.

Replacement and modernization is another major determinant of business fixed investment, with some research indicating that half of outlays for plant and equipment are made for this reason.[7]

Cash flow and the availability of investable funds is another determinant of business investment, although in the Jorgensonian framework the assumptions of perfect capital markets and no balance sheet effects rule out cash flow as a determinant.[8]

The relation between product price and the user cost of capital or the rental price is another key determinant of the desired capital stock, hence business fixed investment. The higher is product price relative to capital costs the greater the profit margin and incentive to add capital stock. The lower are capital costs relative to the cost of labor the more capital is substituted for labor, providing the production technology permits it.

Tax policy is hypothesized to impact on capital spending through the rental price of capital and cash flow. The ITC, tax allowable depreciation lifetimes and the accounting rules for depreciation affect the aftertax net cost of capital goods, the former as a subtraction from the price and the latter through the present value of the stream of tax deductions allowable for tax purposes over the lifetime of the capital asset. There is also a cash flow effect from the tax savings in each period, which provides some of the funds necessary to finance capital outlays and for a reduction in the financial risk associated with firms' balance sheets.

The framework utilized here to analyze business fixed investment reflects interactions between the financial system and real business fixed investment. A key link between the financial and real behavior of business is seen in a measure of the "financial risk" of business, the ratio of debt service to cash flow, as a determinant for the rate of investment. Interest rates enter in the aftertax cost of financial capital, through the discount rate applied to calculate the present value of rental price, and through the ratio of debt service to cash flow. There are also important effects from expected sales, expected capacity utilization, and replacement investment. Disappointment over unexpected changes in sales or less-than-full capacity utilization impact on investment in ways not incorporated the neoclassical Jorgensonian formulation. Finally, the assumptions of perfectly competitive input, output and financial markets, while adequate for initial theoretical work, are far removed from reality and modified for empirical implementation.

The debt service burden, defined as the ratio of interest payments on outstanding corporate debt to business cash flow, is the main variable used to reflect the interaction of financial and real phenomena in business capital expenditures. Since the investment tax credit, accelerated depreciation, and corporate profits taxes all have implications for cash flow and patterns of business financing, there is a liquidity effect on capital outlays from changes in business taxation along with "output" effects and "relative price" effects.

Generally, business tax incentives such as the investment tax credit and accelerated depreciation are believed to have had a bigger positive impact on business capital formation than changes in corporate profits taxes. The rationale is that targeted tax subsidies, which cannot be realized unless the accompanying expenditure is undertaken, will have a bigger "bang-for-a-buck" than general reductions in corporate profits taxes where the proceeds can be expended in many ways. Business tax savings resulting from reductions in corporate profits taxes can be "spent" on labor, capital goods or materials; used to accumulate financial assets such as securities, certificates of deposit or corporate stock; and to retire outstanding debt. The investment tax credit and tax savings from accelerated depreciation can only be realized by making actual outlays on equipment or plant.

Business liquidity also is impacted by tax incentives, but to a lesser extent since the tax savings are obtained only with expenditures on the targeted items. The effect on business liquidity of a change in corporate profits taxes should be greater, since there is no necessary act of spending that accompanies reductions in corporate profits taxes.

The relative impacts of the investment tax credit, accelerated depreciation and corporate profits taxes on capital outlays was definitively examined in Sinai-Eckstein (1983), in both partial equilibrium and full system analysis with feedback, to revisit the impacts of tax incentives on business capital formation and in reply to criticisms by Chirinko-Eisner (1983) on the results obtained in large-scale macroeconometric models for tax effects on business capital formation. Table 6 reproduces the key simulation results from the Sinai-Eckstein (1983) work with the basic equation framework described in Brimmer-Sinai (1976), Sinai (1979), Eckstein (1983), and Sinai-Eckstein (1983).

Table 6 summarizes the "bang-for-a-buck" of the incentives defined in various ways as ratios of increased investment per dollar of tax loss. The single equation or partial equilibrium (without feedback) results are consistent with other studies, showing the investment tax credit to be the most potent business tax incentive, although only narrowly so over accelerated depreciation. Reductions of corporate profits taxes have little effect on business fixed investment, principally because the rental price of capital is hardly changed. In the single equation case, the average gain in real business fixed investment per dollar of ex-ante or static corporate tax loss over five years is $0.52 for the investment tax credit, with a peak of $0.62 in the third year. The corresponding figure for accelerated depreciation is $0.49, with a peak of $0.57 in the second year. In the case of the reductions in corporate profits taxes, the bang-for-a-buck in partial equilibrium is only $0.05.

Bigger impacts are found in complete system simulations (with economy-wide feedback) due to the positive feedback effects of higher output, sales, and profits on the capital outlays for both plant and equipment; also from some offset for the static revenue loss as corporate profits are increased. This is particularly true in the case of accelerated depreciation but much less so with an increase in the equipment investment tax credit. For the latter, the investment that is stimulated generates additional tax reductions.

In the full model simulations reported in Table 6, gains in real investment per dollar loss in revenue appear reasonable for all tax policies. But after allowing for the inflation effects of the economy's response to the tax incentives, averages of the benefit-cost ratios exceed unity. Little basis for comparison exists, since no other evidence of this sort has been offered in any other studies. It does seem clear, however, that the bangs-for-a-buck of single equation studies are too low, given the existence of positive feedback on output, profits, tax

Table 6

'Bang-for-a-buck' of business tax incentives: Single equation and complete-system effects — DRI model for investment tax credit, accelerated depreciation, and reductions of corporate profits taxes.

	Complete system (with feedback)						Partial (without feedback)					
	1981	1982	1983	1984	1985	Avg.	1981	1982	1983	1984	1985	Avg.
	Equipment investment tax credit											
Equipment/taxes	0.79	2.42	1.79	1.24	1.18	1.48						
Equipment investment (72 $'s)/ taxes	0.41	1.16	0.79	0.51	0.45	0.66	0.17	0.57	0.62	0.61	0.60	0.52
Plant investment/tax loss	0.28	0.64	0.46	0.19	0.04	0.33						
Plant investment (72 $'s)/ tax loss	0.11	0.21	0.12	0.04	0.00	0.10						
Business fixed investment/ tax loss	1.06	3.06	2.25	1.44	1.23	1.81						
Business fixed investment (72 $'s)/ tax loss	0.52	1.37	0.91	0.55	0.45	0.76	0.17	0.57	0.62	0.61	0.60	0.52
% Δ equipment investment/ % Δ taxes	0.30	0.95	0.67	0.46	0.43	0.56						
% Δ equipment investment (72 $'s)/ % Δ taxes	0.30	0.95	0.67	0.46	0.43	0.56						
% Δ plant investment/ % tax loss	0.18	0.46	0.32	0.13	0.03	0.22						
% Δ plant investment (72 $'s)/ % Δ tax loss	0.17	0.39	0.24	0.08	0.00	0.18						
% Δ business fixed investment/ % Δ tax loss	0.26	0.77	0.55	0.34	0.29	0.44						
% Δ business fixed investment (72 $'s)/ % Δ tax loss	0.25	0.78	0.54	0.34	0.30	0.44						
	Accelerated depreciation											
Equipment/taxes	0.54	1.42	1.69	1.60	1.42	1.33						
Equipment investment (72 $'s)/ taxes	0.28	0.68	0.75	0.66	0.55	0.58	0.24	0.37	0.35	0.32	0.29	0.31
Plant investment/tax loss	0.37	0.76	0.92	0.86	0.73	0.72						
Plant investment (72 $'s)/ tax loss	0.13	0.28	0.29	0.24	0.19	0.23	0.16	0.20	0.19	0.17	0.15	0.17
Business fixed investment/ tax loss	0.85	2.17	2.61	2.46	2.15	2.05						
Business fixed investment (72 $'s/ tax loss	0.41	0.96	1.04	0.90	0.73	0.81	0.40	0.57	0.54	0.49	0.44	0.49
% Δ equipment investment/ % Δ taxes	0.20	0.56	0.64	0.59	0.52	0.50						
% Δ equipment investment (72 $'s)/ % Δ taxes	0.20	0.56	0.63	0.59	0.57	0.50	0.18	0.30	0.30	0.29	0.27	0.27
% Δ plant investment/ % Δ tax loss	0.20	0.54	0.64	0.57	0.48	0.49						
% Δ plant investment (72 $'s)/ % Δ tax loss	0.20	0.51	0.57	0.50	0.41	0.44	0.24	0.37	0.37	0.35	0.33	0.33
% Δ business fixed investment/ % Δ tax loss	0.20	0.55	0.64	0.59	0.51	0.50						
% Δ business fixed investment (72 $'s)/ % Δ tax loss	0.20	0.54	0.62	0.56	0.49	0.48	0.20	0.32	0.32	0.31	0.29	0.29
	Corporate profits tax reductions											
Equipment/taxes	0.29	0.40	0.26	0.15	0.14	0.25						
Equipment investment (72 $'s)/ taxes	0.15	0.19	0.11	0.06	0.05	0.11	0.02	0.04	0.03	0.03	0.03	0.03
Plant investment/tax loss	0.23	0.36	0.29	0.20	0.18	0.25						
Plant investment (72 $'s)/ tax loss	0.29	0.12	0.09	0.05	0.05	0.08	0.01	0.02	0.02	0.02	0.02	0.02
Business fixed investment/ tax loss	0.52	0.76	0.56	0.35	0.33	0.50						
Business fixed investment (72 $'s)/ tax loss	0.24	0.32	0.20	0.11	0.09	0.19						
% Δ equipment investment/ % Δ taxes	0.11	0.16	0.10	0.06	0.05	0.09						
% Δ equipment investment (72 $'s)/ % Δ taxes	0.11	0.16	0.10	0.05	0.05	0.09	0.01	0.03	0.03	0.03	0.03	0.03
% Δ plant investment/ % Δ tax loss	0.15	0.26	0.20	0.13	0.12	0.17						
% Δ plant investment (72 $'s)/ % Δ tax loss	0.14	0.23	0.17	0.11	0.10	0.15	0.01	0.04	0.04	0.04	0.04	0.04
% Δ business fixed investment/ % Δ tax loss	0.12	0.19	0.14	0.08	0.08	0.12						
% Δ business fixed investment (72 $'s)/ % Δ tax loss	0.12	0.18	0.12	0.07	0.06	0.11	0.01	0.04	0.03	0.03	0.03	0.03

Source: "Tax Policy and Business Fixed Investment Revisited" by Allen Sinai and Otto Eckstein receipts, and the price level. The implicit assumption in partial equilibrium analysis of an unchanging price level is not plausible.

In the complete system simulations, the tax incentives show considerably greater impacts than in the single equation or partial equilibrium results. The ranking for the three tax programs, based on averages calculated over five years, favors accelerated depreciation, the investment tax credit, then reductions in corporate profits taxes. The ratios of the real gain in business fixed investment per dollar of corporate tax loss are $0.81 ($0.58 for equipment and $0.23 for plant, accelerated depreciation), $0.76 (investment tax credit), and $0.19 ($0.11 for equipment and $0.09 for plant, corporate profits taxes), increases of 50% to 100% over the single equation results. Since there is no tax credit on plant, the investment tax credit would be first if a ranking were made only on the basis of equipment investment. The total elasticities of response averaged 0.48 for the tax credit, 0.44 for accelerated depreciation, and 0.11 for the reduction in corporate profits taxes.

The ratios for nominal business capital expenditures are well in excess of unity in the case of accelerated depreciation and the investment tax credit, reflecting a rising price level as well as the positive feedback of a higher output on equipment and plant investment. More relevant are the elasticity coefficients, showing the percentage response of nominal investment to a percentage change of tax receipts. These are all well below unity, with the accelerated depreciation program impacting the most (because it affects plant as well as equipment), then the tax credit, and finally the corporate profits tax reductions.

In earlier work, Brimmer-Sinai (1976) used the framework developed for the DRI model to analyze the effects of various tax incentives on both capital formation and business liquidity. Tables 7 and 8 provide some key findings from that study.

In the Brimmer-Sinai work, each tax subsidy raised business fixed investment, the stock of plant and equipment, and the capacity of the economy as measured by potential GNP. The instrument effectiveness, defined as the ratio of the five-year average for changes in real business fixed investment to the ex-ante revenue loss for all corporations, was greatest for a policy of indexing depreciation to inflation. Per dollar loss of tax revenue, there was an average $0.63 gain in real capital expenditures for the depreciation measure, a $0.33 rise from the investment tax credit, and a $0.14 increase from reductions in corporate profits taxes.

The superiority of the depreciation measure, relative to the tax credit, stems from a combination of higher outlays and a smaller revenue loss. The revenue loss from the depreciation measure was only $1.9 billion for 1976 to 1980, compared with $2.7 billion for the investment tax credit. With depreciation tied

Table 7

EFFECTS OF TAX POLICY ON BUSINESS CAPITAL FORMATION (NONACCOMMODATING MONETARY POLICY, ENTRIES RELATIVE TO BASELINE SOLUTION)*

	1976	1977	1978	1979	1980	5-Year Average
Business Fixed Investment (Bils. of 1958 $'s)						
Investment Tax Credit	0.4	0.9	0.9	1.0	1.1	0.9
Profits Tax Rate	0.4	0.9	1.2	1.8	2.1	1.3
Depreciation Rule	0.5	1.4	1.5	1.5	1.3	1.2
Capital Stock-Plant (Bils. of 1958 $'s)						
Investment Tax Credit	0.1	0.2	0.3	0.4	0.5	0.3
Profits Tax Rate	0.1	0.4	0.8	1.4	2.1	1.0
Depreciation Rule	0.1	0.4	0.7	1.2	1.6	0.8
Rental Price for Equipment (Index, % Change)						
Investment Tax Credit	−3.3	−2.5	−2.9	−3.5	−3.4	−3.1
Profits Tax Rate	0.0	1.0	0.5	1.1	0.5	0.6
Depreciation Rule	−3.8	−3.3	−2.4	−2.4	−2.5	−2.9
Rental Price for Plant (Index, % Change)						
Investment Tax Credit	0.4	1.4	0.9	0.3	0.4	0.7
Profits Tax Rate	−1.1	−0.1	−1.5	−0.8	−1.6	−2.0
Depreciation Rule	−2.5	−2.6	−2.1	−2.3	−2.4	−2.4
Cash Flow (Nonfinancial Corporations, $ Bils.)						
Investment Tax Credit	2.0	1.7	1.8	2.5	2.6	2.1
Profits Tax Rate	3.0	3.0	7.3	8.7	10.8	6.6
Depreciation Rule	2.7	2.5	2.3	3.2	3.3	2.8

* Investment Tax Credit: permanent increase in rate of investment credit on equipment from 10 to 12 per cent, beginning in 1976:1

Profits Tax Rate: two-stage reduction of corporate profits tax rate from 48 to 42 per cent in 1976:1 and 1978:1

Depreciation Rule: indexing depreciation at historical cost to the current rate of inflation for plant and equipment

Source: "The Effects of Tax Policy on Capital Formation, Corporate Liquidity, and the Availability of Investable Funds; a Simulation Study, Journal of Finance, May 1976, pp. 287-308.

Table 8

MEASURES OF LIQUIDITY AND BALANCE SHEET STRENGTH FOR NONFINANCIAL CORPORATIONS (NONACCOMMODATING MONETARY POLICY)

	1976	1977	1978	1979	1980
Cash Flow/Capital Outlays[1]					
Baseline	.78	.77	.79	.82	.77
Investment Tax Credit	.79	.78	.80	.82	.77
Profits Tax Rate	.80	.79	.83	.85	.80
Depreciation Rule	.80	.78	.80	.82	.77
Financial Assets/Short-Term Liabilities[2]					
Baseline	.54	.53	.52	.53	.53
Investment Tax Credit	.55	.54	.52	.54	.53
Profits Tax Rate	.55	.56	.55	.58	.58
Depreciation Rule	.55	.55	.52	.54	.54
Debt Burden Proxy/Cash Flow[3]					
Baseline	.36	.35	.32	.29	.28
Investment Tax Credit	.35	.34	.31	.29	.27
Profits Tax Rate	.35	.34	.30	.27	.25
Depreciation Rule	.35	.34	.31	.28	.27
Debt/Equity[4]					
Baseline	2.26	2.39	2.49	2.53	2.59
Investment Tax Credit	2.24	2.35	2.44	2.48	2.53
Profits Tax Rate	2.23	2.33	2.36	2.35	2.34
Depreciation Rule	2.27	2.38	2.47	2.51	2.56

[1] Cash flow is retained earnings plus depreciation and the inventory valuation adjustment; capital outlays are the sum of plant and equipment expenditures, inventory accumulation and residential construction.

[2] Financial assets are the total of money, deposits, U. S. Government bonds, State and local government bonds, and commercial paper; short-term liabilities are bank loans plus open market paper plus finance company loans plus U. S. Government loans.

[3] Debt burden proxy is a weighted average of outstanding bank loans, bonds, and open market paper. The weights are the relevant current and past rates of interest.

[4] Debt is short-term liabilities less U. S. Government loans but including miscellaneous liabilities, bonds and mortgages; equity is outstanding stock plus retained earnings.

Source: "The Effects of Tax Policy on Capital Formation, Corporate Liquidity, and the Availability of Investable Funds; a Simulation Study, Journal of Finance, May 1976, pp. 287-308.

to inflation in this analysis and an effective tax rate of 33.7%, the tax loss from the depreciation policy was small and indirect. Under the tax credit, 2% of all new equipment spending was directly lost to the Treasury--for a much higher dollar amount.

The tax incentives analyzed improved business liquidity and strengthened the balance sheet somewhat. The ratio of internally generated funds to capital outlays rose in all cases, easing the need for external finance. The impact was concentrated in the initial three years of the policy, then diminished as the lagged effects of the tax incentives and capital outlays began to show. The proportion of debt service relative to cash flow was reduced compared with the baseline. To the extent business tax reform improved the liquidity and balance sheet ratios of corporations, firms' creditworthiness was helped and the cost of capital reduced. The improved financial position for business with investment tax incentives is a benefit not typically considered, but an important one in the contemporary U.S. economy. Presumably, removing the investment tax incentives would worsen business liquidity and balance sheets.

The Effects of Business Taxes on Capital Spending--1981 to 1984: A New Analysis

A boom in capital expenditures occurred in the U.S. economy during 1984 (Table 9). Indeed, one of the surprises of the business expansion was the strong behavior of business capital formation during 1983-84 in the aftermath of a deep recession and in the face of extraordinarily high nominal and real interest rates. Business equipment and plant spending, in real terms, rose 2.5% in 1983, the first time in the postwar era that capital spending rose in the year following a recession. A record 19.8% increase occurred in capital spending during 1984. Table 10 shows that real business fixed investment has risen 34.9% since the current expansion began, almost twice times the average increase for this aggregate in the five previous expansions that have lasted nine quarters. Some $51.5 billion of increased nonresidential fixed investment has occurred, compared with only $11.7 billion, on average, across five other expansions of comparable length.

Why has there been so large an increase in business fixed investment? Table 11 shows the composition of the increases since November 1982 for both equipment and structures. From the table, it can be seen that the boom occurred mainly in equipment: office machinery including computers, autos, light trucks, buses, and communication equipment. In structures, the pace of expenditures picked up later, and was concentrated in commercial buildings and public utility structures.

There are four possible reasons for the surge in business capital spending. First, the economy grew strongly in 1983 and 1984, especially in the nongoods-producing sectors. As a result,

Table 9
Performance for Business Fixed Investment
(Billions of 1972 Dollars)

Year	Total	Percent	Equipment	Percent	Structures	Percent
1970	113.9	-2.5	69.9	-2.7	43.9	-2.3
1971	112.2	-1.5	69.4	-0.8	42.9	-2.5
1972	121.0	7.9	76.8	10.8	44.2	3.0
1973	138.1	14.1	90.7	18.0	47.4	7.3
1974	135.7	-1.7	92.1	1.5	43.6	-7.9
1975	119.3	-12.1	81.1	-11.9	38.3	-12.3
1976	125.6	5.3	86.1	6.2	39.5	3.2
1977	140.3	11.7	99.9	16.0	40.4	2.3
1978	158.3	12.9	113.7	13.8	44.6	10.5
1979	170.0	7.4	120.8	6.3	49.1	10.0
1980	165.8	-2.4	117.0	-3.1	48.8	-0.7
1981	175.0	5.6	121.8	4.1	53.2	9.1
1982	166.9	-4.7	113.6	-6.8	53.4	0.3
1983	171.0	2.5	121.8	7.2	49.2	-7.8
1984	204.9	19.8	148.0	21.5	56.9	15.6

Table 10
Performance of the U.S. Economy, By Sector

	Change Since 1982:4		Average Change* of 5# Previous Expansions	
	Billions of Constant Dollars	Percent Change	Billions of Constant Dollars	Percent Change
Real Gross National Product	184.7	12.5	99.9	11.6
Consumption	112.8	11.6	59.1	10.0
Investment	114.3	64.3	36.7	32.7
Fixed Investment	70.6	34.9	24.3	20.8
Nonresidential	51.5	31.9	11.7	14.1
Residential	19.2	47.1	12.7	37.4
Inventories	43.7	NM	12.3	NM
Government	10.1	3.4	5.2	2.6
Federal	5.0	4.0	-2.4	-2.5
State & Local	5.1	2.9	7.6	7.2
Net Exports	-52.5	-217.8	-1.1	-9.1

NM=Not Meaningful

* Change is over nine quarters following each trough.

# The 1980-81 expansion was excluded because its duration was less than nine quarters and 1949-53 was dropped as atypical.

Table 11
Investment In Nonresidential Producers Durable Equipment In Latest Expansion
(Billions of Dollars)

	1982:4	1983:1	1983:2	1983:3	1983:4	1984:1	1984:2	1984:3	1984:4	1985:1	1982:4 to 1985:1	
											Chg	%Chg
Office Machinery, etc.	26.9	30.1	31.7	33.3	33.3	37.0	38.4	40.7	41.7	39.5	12.6	46.9
Autos	9.7	10.5	11.5	13.5	14.0	16.5	17.1	17.6	16.2	18.4	8.7	89.7
Buses, Trucks, Trailers	7.2	7.3	7.6	8.5	10.6	10.9	12.8	13.0	14.2	13.5	6.3	88.5
Communication Equipment	13.9	13.8	14.1	13.4	16.0	15.3	15.7	17.1	18.3	18.4	4.5	32.4
Other Furniture	3.3	3.3	3.4	3.9	4.3	4.3	4.3	4.5	4.7	4.9	1.6	47.6
Metalworking Machinery	3.3	3.4	3.5	3.9	4.1	4.6	4.8	5.0	5.0	4.9	1.5	46.4
Fabricated Metals	3.0	3.1	3.2	3.3	3.4	3.5	3.5	3.7	4.0	4.3	1.2	41.1
Construction Machinery	1.0	0.7	1.6	1.8	2.2	1.9	2.1	2.1	2.1	2.1	1.2	117.0
Instruments	3.6	3.7	3.7	4.0	4.0	4.2	4.3	4.6	4.4	4.6	1.0	29.1
Special Machinery	3.6	3.6	4.0	4.3	4.3	4.5	4.9	5.0	4.8	4.6	1.0	28.6
Electrical Apparatus	4.5	4.5	4.6	4.9	5.2	5.3	5.5	5.8	5.7	5.4	0.9	21.2
Photographic Equipment	7.3	7.0	7.0	7.3	7.9	8.0	8.9	8.3	8.0	8.2	0.8	11.3
General Industrial Mach	4.3	4.1	4.0	4.5	4.4	4.8	4.8	5.1	4.8	4.9	0.7	15.3
Other	2.6	2.6	2.7	2.7	3.0	3.1	3.1	3.0	3.0	3.2	0.6	23.2
Service Machinery	2.5	2.4	2.6	2.7	2.9	2.8	3.1	3.1	3.1	2.9	0.5	19.3
Electrical Equipment Nec	1.4	1.5	1.6	1.7	1.8	1.9	1.8	1.9	1.8	1.8	0.4	25.9
Farm Tractors	1.2	1.1	1.5	1.5	1.8	1.8	1.8	1.6	1.8	1.5	0.3	22.4
Household Furniture	0.6	0.7	0.8	0.8	0.8	0.8	0.8	0.8	0.9	0.9	0.2	37.1
Steam Engines	0.9	0.7	0.7	0.7	0.9	0.5	0.6	0.9	1.1	1.1	0.2	20.4
Construction Tractors	0.1	0.2	0.2	0.2	0.3	0.2	0.3	0.3	0.3	0.3	0.1	115.3
Aircraft	2.7	2.9	2.3	2.4	2.4	2.1	1.9	2.6	2.9	2.8	0.1	3.7
International Combustion Engine	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.1	58.3
Railroad Equipment	0.8	0.7	0.7	0.8	0.8	0.9	1.0	1.1	1.0	0.9	0.1	11.4
Mining Machinery	2.3	2.0	2.0	2.1	2.1	2.1	2.4	2.4	2.4	2.3	0.1	3.3
Household Appliances	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.0	30.2
Ships and Boats	0.9	0.7	0.5	0.6	0.7	0.5	0.6	0.7	0.8	0.7	-0.2	-21.6
Agricultural Machinery	2.2	1.9	1.9	1.7	2.0	1.7	1.5	1.5	1.6	1.5	-0.7	-32.7
Less: Sale of Scrap	-0.4	-0.4	-0.4	-0.5	-0.5	-0.5	-0.5	-0.6	-0.6	-0.6	-0.2	59.0
Total	109.7	112.5	117.2	124.3	133.1	139.2	146.0	152.4	154.4	153.4	43.7	39.9

Investment In Nonresidential Structures
(Billions of 1972 Dollars)

	1982:4	1983:1	1983:2	1983:3	1983:4	1984:1	1984:2	1984:3	1984:4	1985:1	1982:4 to 1985:1	
											Chg	%Chg
Commercial Building	16.1	15.2	14.8	15.7	16.2	18.2	20.4	20.6	22.7	24.2	8.1	50.3
Public Utilities	12.4	11.7	11.8	11.1	12.6	12.4	12.9	13.4	13.2	13.7	1.3	10.2
Miscellaneous Buildings	2.6	2.8	2.8	3.0	3.5	4.0	4.1	3.8	3.9	3.9	1.3	47.6
All Other Private	0.6	0.6	0.7	0.6	0.6	0.6	0.7	0.8	0.9	1.1	0.5	89.9
Petroleum	6.6	6.3	6.0	5.8	7.3	6.6	6.4	6.6	6.6	6.8	0.1	2.2
Net Purchases Used Structures	-0.2	-0.2	-0.2	-0.1	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	0.1	-64.3
Religious	0.8	0.7	0.7	0.8	0.8	0.9	1.0	0.9	0.9	0.9	0.1	10.9
Brokers' Commissions	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.3	0.1	26.5
Educational	0.6	0.6	0.6	0.6	0.6	0.7	0.6	0.6	0.6	0.6	0.0	3.6
Farm	1.5	1.4	1.6	1.7	1.6	1.8	1.3	1.3	1.2	1.4	0.0	-2.6
Mining	0.7	0.7	0.6	0.5	0.4	0.4	0.5	0.5	0.5	0.5	-0.2	-26.7
Hospital & Institutional	2.8	2.9	2.8	2.8	2.8	2.9	2.9	2.6	2.4	2.3	-0.5	-16.8
Industrial Buildings	7.2	6.0	5.6	5.5	4.8	5.8	5.9	5.9	6.2	6.2	-1.0	-13.8
Total	51.9	49.0	48.1	48.3	51.4	54.1	56.8	57.1	59.4	61.8	9.9	19.1

Miscellaneous Buildings includes hotels and motels, buildings used primarily for social and recreational activities and buildings not classified.

business geared up to meet the increasing sales by raising expenditures on equipment and plant. This is the traditional sales accelerator impact. Second, the business tax incentives may have generated the large increase. Certainly, the heavy concentration of investment in items eligible for the enhanced tax credit and more rapid depreciation, especially equipment and commercial buildings, major beneficiaries of the ACRS, suggest that the ERTA tax incentives were of great importance. Third, there was a need for replacement investment, modernization and cost-cutting, embodied in the new technological investments that pushed business capital spending higher. The Office Machinery and Communications categories of equipment (which include computers) benefited most from these factors. Last, the cash flow effects of the business tax incentives were substantial, especially in real terms with surprisingly low inflation rates.

The allocative effects of the enhanced tax incentives of the past few years are not analyzed here, although admittedly biased toward equipment and certain categories of capital assets because of the enhanced investment tax credit and new ACRS. The efficiency losses associated with the equipment tax credits and ACRS could be substantial, and it is an open question as to the relative evaluation of the growth and efficiency effects of the various tax incentives. Removing them should diminish allocative inefficiencies and provide some benefits to the economy on these grounds. Weighing the increases of efficiency versus the consequence of losses in aggregate capital outlays is a relevant, but difficult, issue, not dealt with here.[9]

To evaluate the impacts of the ERTA-TEFRA-DEFRA tax changes over 1981 to 1984, partial equilibrium and full system simulations were run with models developed at Shearson Lehman Brothers for business equipment and plant and for the complete U.S. economy. In the equations used, one major criticism of past studies was dealt with--the separation of "output" effects from "relative price" and "tax" effects. The new models separate the expected sales or output variable from relative price and tax effects, reducing whatever upward bias might exist in a Jorgenson-type multiplicative variable where the assumption of a long-run unitary elasticity of capital stock with respect to relative prices is imposed a priori. Reestimates of equations for equipment and plant expenditures through 1984 indicate that separate variables for changes in sales and changes in the ratio of product price to rental price provide a better specification. The cash flow effects in the equation framework remain as has been described in Sinai-Eckstein (1983), although with less of an impact. The equation results can be found in the Appendix.

Table 12 provides some estimates of the impacts on business fixed investment of enhancing the investment tax credit and the increase of accelerated depreciation from 1981 to 1984. The estimated effects in this table reflect the partial equilibrium impacts of the changes in tax policy, with no feedback effects either through the increased replacement investment generated by a higher capital stock or the flow-through of increased

Table 12
Effects on Business Fixed Investment of Accelerated Depreciation and ITC
(Single Equation and Capital Stock Feedback)
(Billions of 1972 Dollars, Percent of Baseline in Parenthesis)

	1981	1982	1983	1984
Single Equation				
Total Business Fixed Investment	0.6	5.2	5.1	3.6
	(0.4)	(3.2)	(3.1)	(1.8)
Equipment	0.3	3.0	4.2	3.0
	(0.3)	(2.7)	(3.5)	(2.1)
Plant	0.3	2.2	0.9	0.5
	(0.5)	(4.3)	(2.0)	(1.0)
With Capital Stock Feedback				
Total Business Fixed Investment	0.6	5.6	6.5	6.1
	(0.4)	(3.5)	(4.0)	(3.1)
Equipment	0.3	3.3	5.4	5.3
	(0.3)	(3.0)	(4.5)	(3.7)
Plant	0.3	2.3	1.2	0.8
	(0.6)	(4.5)	(2.6)	(1.6)

investment spending to output, cash flow, and back to investment again. Table 12 also contains the results if an indigenous response is permitted for capital stock and the subsequent replacement of that capital stock.

Business fixed investment, in real terms, is seen to be up over $5 billion in each of 1982 and 1983 where no feedback occurs, more than 3% of the baseline figures, because of the enhanced ITC and ACRS, with most of the increase in equipment.

With feedback of the increased investment to capital stock and replacement investment of the additional capital stock, the results are larger, showing a $5.6 billion increase in total business fixed investment in 1982 compared with the baseline, $6.5 billion in 1983, and $6.1 billion in 1984. Again, the increases are greatest for equipment, outlays, the major beneficiary of the ACRS and enhanced ITC. Some 3.1% to 4% of the baseline investment shows up as an increase with the tax incentives.

Table 13 shows the impacts on business fixed investment of the increased ITC and ACRS in full model simulation. Monetary policy is kept unchanged, with the money stock (M1) returned to the baseline values after removal of the ERTA-TEFRA-DEFRA provisions.

A sizeable rise of business fixed investment is shown in the full model simulation, with a $7.8 billion increase in 1982, split $4.7 billion for equipment and $3.0 billion for plant. The increased compared with the baseline are also substantial in 1983 and 1984, $6.0 billion and $5.9 billion, respectively. The time distribution of response to the changes in the ITC and accelerated depreciation indicates a peak effect in the second year and early in the third year from the changes in business taxation. This is somewhat quicker than has been shown in previous studies, but is consistent with the greater influence of accelerated depreciation in the more recent tax law changes. The fading away of the impact in 1984 likely reflects some offset from TEFRA in the form of higher business taxes in that year.

The bang-for-a-buck of the changes in taxes over 1981 to 1984, ex-post, is indicated in Table 14.

A substantial rise in business fixed investment, in 1972 dollars, is indicated per dollar of tax revenue loss in the partial equilibrium or single equation simulations. The partial equilibrium results, without feedback, show a peak $0.54 increase in total business fixed investment per dollar of revenue loss in 1982, with a fading to $0.31 in 1983 and $0.18 in 1984. The four-year average is $0.39. In the complete model simulation with feedback, the increase in business fixed investment per dollar of revenue loss peaks at $1.18 in 1982 and remains fairly high at $0.37 in 1983 and $0.25 in 1984. The four-year average is $0.51. The mix is heavily concentrated in equipment as opposed to plant.

Table 13
Effects on Business Fixed Investment of
Accelerated Depreciation and ITC
(Constant Monetary Policy Assumed)
(Full Model)
(Billions of 1972 Dollars, Percent of Baseline in Parenthesis)

	1981	1982	1983	1984
Total Business Fixed Investment	0.9	7.8	6.0	5.9
	(0.5)	(4.1)	(3.7)	(3.2)
Equipment	0.5	4.7	4.9	5.4
	(0.5)	(3.6)	(4.2)	(4.0)
Plant	0.4	3.0	1.1	0.6
	(0.7)	(5.1)	(2.5)	(1.2)

Table 14
"Bang-for-a-Buck" Calculations:
Effects on Business Fixed Investment of
Accelerated Depreciation and ITC
(Single Equation and Full Model)
(Change in Business Investment Relative to Change in Taxes)
(1972 Dollars)

	1981	1982	1983	1984	Average
Single Equation					
Total Business Fixed Investment	0.13	0.54	0.31	0.18	0.39
Equipment	0.06	0.31	0.25	0.15	0.19
Plant	0.06	0.23	0.05	0.02	0.09
Full Model (constant monetary policy assumed)					
Total Business Fixed Investment	0.23	1.18	0.37	0.25	0.51
Equipment	0.14	0.72	0.30	0.22	0.35
Plant	0.09	0.46	0.07	0.02	0.16

Table 15 presents the results if a corporate profits tax rate increase had been used to offset the loss in tax revenue due to changes in the ITC and accelerated depreciation during 1981 to 1984. The equivalent corporate profits tax rate changes are seen to provide considerably less business fixed investment per dollar of revenue loss than the combination of the enhanced ITC and ACRS, demonstrating once again that the instrument effectiveness of business profits tax reductions is less than the targeted tax incentives.

Finally, Table 16 shows the ex-post loss in revenues from the ITC, ACRS, TEFRA, and DEFRA business tax provisions. Reducing business taxes should help pay for itself through the stronger economy that is induced. the "reflow" is seen to be about $0.15 per dollar of tax reduction, on average, over the four years. That is, for a dollar of tax reduction because of the enhanced ITC and accelerated depreciation, fifteen cents ultimately flow back to the Treasury in the form of higher corporate tax receipts because of an improved economy. Thus, to some extent, the business tax cuts are "self-financing," although far from paying for themselves.

Tax Reform Impacts on Business Fixed Investment: The Initial Assessment

From the previous analysis, it seems that elimination of the ITC, limitations on accelerated depreciation, and the recapture of windfall tax savings will more than offset any positive impacts on business fixed investment from reductions in corporate profits taxes, the 10% deductibility of dividends, and indexation of inventories to inflation. The recapture of windfall tax savings can be viewed as a negative offset to the reductions of corporate profits taxes, although to be concentrated on only those firms that claimed the most accelerated depreciation in 1981 to 1985, limiting cash flow but not affecting the cost of capital. The 10% deductibility of dividends should lower the cost of capital by increasing dividends paid and encouraging a small shift from debt to equity financing. Increased dividend payouts would tend to raise stock prices and reduce the cost of equity financing. Finally, indexing inventories by adjusting taxes on the real increases in inventories and not the increases attributable to inflation also will result in a tax cut by raising expensable costs, essentially reducing the total tax paid by business but not impacting on the rental price of capital.

Beyond 1990, the CCRS could be more stimulative to business capital formation than ACRS if inflation rates are higher. The present value for the tax deductible stream of depreciation under CCRS is actually higher in situations of 8% inflation or more, since the basis for depreciation can be indexed to inflation. The negative impact on business fixed investment is greater in 1986 to 1989. The recapture tax ends by 1989, in effect lowering the effective tax rate for many companies. But taken in total,

Table 15
Effects on Business Fixed Investment of a Corporate Tax Rate Change Equivalent* to Accelerated Depreciation and ITC Changes

	1981	1982	1983	1984	Average
Total Business Fixed Investment	0.1	2.2	4.9	5.5	3.2
	(0.1)	(1.2)	(3.0)	(3.0)	(1.8)
Equipment	0.1	1.2	2.8	3.6	1.9
	(0.1)	(0.9)	(2.4)	(2.6)	(1.5)
Plant	0.1	1.1	2.1	1.9	1.3
	(0.1)	(1.6)	(4.7)	(4.0)	(2.7)

"Bang-for-a-Buck"
(Change in Business Investment Relative to Change in Taxes)
(Ratio)

	1981	1982	1983	1984	Average
Total Business Fixed Investment	0.02	0.33	0.30	0.23	0.22
Equipment	0.02	0.20	0.25	0.21	0.17
Plant	0.01	0.13	0.06	0.02	0.06

*Equivalent in the sense that it would produce the same static federal corporate tax revenue changes.

Table 16
Ex-Post Static Federal Corporate Tax Revenue Losses from the ITC and ACRS, TEFRA, and DEFRA
(Billions of Dollars)

	ITC	ACRS, TEFRA, and DEFRA	Total
1981	1.1	3.0	4.1
1982	1.1	7.1	8.2
1983	1.1	14.6	15.7
1984	1.3	21.3	22.6
Total	4.6	46.0	50.6

Ex-Post Dynamic Federal Corporate Tax Revenue Losses from the ITC and ACRS, TEFRA, and DEFRA
(Full Model Simulation)
(Billions of Dollars, Percent of Initial Tax Loss)

1981	3.9	95.1
1982	6.5	79.3
1983	13.6	86.6
1984	19.8	87.6
Total	43.8	86.6

Source: Shearson Lehman Economic and Financial Markets.

except for the possible situation of much higher inflation, the path of business fixed investment still would be significantly lower than under the current system, largely because of the negative impact from elimination of the ITC and the effects of lessened depreciation in the early years of capital outlays.

Another negative impact, not measured here, will mean less use of leasing arrangements to finance capital goods use. Firms without tax liabilities have been able to lease equipment from firms who have purchased equipment to use the credits to reduce their tax liability. Leasing financed one-fourth of all equipment spending in 1984 and would be severely curtailed under the tax reform proposals.

An approximation to the loss in business fixed investment over the next five years from the changes in business taxation can be obtained by applying the bang-for-a-buck calculations of Tables 14 and 15.[10] However, it should be noted that the calculations do not include the positive impacts on business investment stemming from the increased sales associated with the reductions in personal income taxes.

In real terms, the ERTA-TEFRA-DEFRA tax changes were estimated to have increased equipment and plant outlay by $0.51 per dollar of lost tax revenues in 1981 to 1984, with the time distribution $0.23, $1.18, $0.37 and $0.25, respectively. Applying these ratios to the estimated tax increases from the removal of the ITC and substitution of CCRS for ACRS (Table 17) provides an estimated decline of about $16.9 billion per year in real business fixed investment over 1986 to 1990, or $40 billion per annum in nominal terms. The time distribution would be $3.3 billion, $29.4 billion, $11.7 billion and $10.5 billion over 1986 to 1989. Using the estimated instrument effectiveness for an equivalent change in corporate profits taxes during 1981 through 1984 (Table 15) and the estimated figures for net tax reductions in Table 17 produces an offsetting effect of a positive $6.1 billion a year in business fixed investment over the next five years. The net reduction in business fixed investment is thus $10.8 billion a year, or $54.0 billion of reduced business fixed investment in real terms for 1986 to 1990, 25.7% of the current rate of business fixed investment. Year-by-year, the figures are $3.2 billion, $25.1 billion, $3.8 billion, and $0.9 billion from 1986 to 1989. Real GNP growth would be about two percentage points less a year than otherwise, given these figures. In 1987, these results suggest that as much as 4 or 5 percentage points in growth would be lost.

Summary

The changes in business taxation of the Reagan tax reform plan would severely limit business fixed investment over the next five years. This is an inevitable consequence of removing many of the previously existing subsidies for business capital formation. Targeted tax incentives are to be reduced by $33.1 billion over the next five years with an offsetting reduction of $27.5 billion

Table 17
Tax Changes Affecting Business Capital Spending and Liquidity in the Administration Plan

	Year						
	1986	1987	1988	1989	1990	Total	Average
Negative Impacts							
1. Removal of ITC	14.0	25.6	29.4	33.3	37.4	139.7	27.9
2. Limitation of Accel. Deprec. CCRS Instead of ACRS	0.3	-0.7	2.3	8.7	15.4	26.0	5.2
3. Recapture of Windfall Gains	7.6	19.4	20.4	9.1	--	56.5	11.3
Total "A"	21.9	44.3	52.1	51.1	52.8	222.2	44.4
Positive Impacts							
1. Profits Tax Reductions	-10.0	-26.7	-35.9	-39.0	-41.8	-153.4	-30.7
2. 10% Deduct. Divs.	--	-3.4	-6.2	-7.2	-8.0	-24.8	-4.9
3. Indexation of Invens.	--	-2.4	-4.5	-4.5	-4.5	-15.9	-3.2
Total "B"	-10.0	-32.5	-46.6	-50.7	-54.3	-194.1	-38.8
Net (Total "A" Minus Total "B")	11.9	11.8	5.5	0.4	-1.5	28.1	5.6

Sources: Department of Treasury and The White House.

in nontargeted taxes. Since the targeted tax incentives for business fixed investment have a greater bang-for-a-buck than the nontargeted taxes, business capital outlays and capital formation must necessarily be lower.

Econometric estimates for the impact of tax incentives under ERTA-TEFRA-DEFRA from 1981 to 1984 showed a significant positive impact on business capital spending. In complete computer simulations with models developed at Shearson Lehman Brothers, some 3% to 4% of business fixed investment over these years was estimated to have resulted from the business tax incentives. The peak effects were in 1982 and 1983, $7.8 billion and $6 billion respectively. The instrument effectiveness or bang-for-a-buck of the various types of tax changes were estimated to be an average of $0.51 for the ITC and ACRs and $0.22 for corporate profit taxes over this period. The equation framework used, summarized in the Appendix, incorporates separate effects for changes in expected sales, changes in the ratio of product price to the rental price of expected replacement investment corrected for utilization rates, and the role of cash flow in affecting outlays for equipment and plant. The equations for producers' durable equipment and plant differed from previous work in that the "relative price" effects were estimated as separate variables instead of multiplicatively.

For the future it was determined that the major changes in business taxes under the Reagan proposals would cause a $10.8 billion per year reduction in real business fixed investment with the bulk of the impact in 1987 and early 1988. Most of the drop would occur in equipment spending, reversing the trend of capital outlays toward more equipment and less plant of the past 20 years. A total of $54 billion of real business fixed investment would be lost over the next five years: the equivalent of two to three percentage points of real economic growth each year. The capacity for goods production would rise more slowly as a result, with a greater potential for inflationary pressure as the economy moved closer to full employment.

There are several implications to be drawn:

1) Capital goods spending will be considerably lower in coming years under the tax reform proposals of the Reagan Administration. The analysis here held constant any positive shifts in consumption and investment demand that might arise from the proposed reductions in personal income taxes. Even allowing for this factor, however, there would likely still be a sizeable net loss for investment.

2) Liquidity and business saving would be reduced, with the net increases in business taxes limiting cash flow. The borrowing of business most likely would be reduced, since the business tax incentives have never been totally self-financing. The liquidity ratios reflecting the financial health of American business, especially the large capital goods companies, would likely worsen.

3) Less output, profits, employment, and more upward pressure on prices from less productive capacity as the economy approaches full employment are also predictable results. The lessened capital formation, along with the increased consumer spending that would result from the full tax reform program, likely would be mildly inflationary, especially in the outyears.

4) The negative impacts from the increased business taxation would come at a time when U.S. manufacturing is in a state of decline. This weakness would be intensified, since American U.S. capital goods spending would be reduced. The industrial base of the U.S. economy likely would shrink further, damaging U.S. competitiveness abroad.

The changes in business taxation recommended by President Reagan make sense from an efficiency point of view, lessening the distortions across industries and asset categories that were increased under the ERTA-TEFRA-DEFRA tax changes. Also, the changes are desirable if there is no national goal to enhance capital formation. But increasing business capital formation and raising saving were important goals for the economy just a few years ago. The abrupt turnaround in national objectives is a surprise and breaks the implicit "contract" of the government with the business sector. Also, there are potentially damaging effects on inflation, U.S. competitiveness, and business aftertax profits with the new tax changes.

Coming on top of considerable weakness in the U.S. economy and a worsening competitive position abroad, the wisdom of having the business tax increases fully take effect in 1986 is questionable. The error of ERTA was in overdoing the accelerated depreciation of ACRS, which was set for a situation of expected high inflation. Scaling back the business tax incentives and phasing in the new tax measures may make more sense than the abrupt changes of the Reagan tax reform proposals. These almost certainly will shrink an already shrinking industrial base and make even more difficult the already difficult task of competing with foreign producers.

Footnotes

*Chief Economist and Managing Director, Shearson Lehman Brothers Inc. and Adjunct Professor of Economics, Graduate Business School, New York University. Ed Friedman and Cary Leahey of Shearson Lehman Brothers performed the computational work.

[1] Estimates of revenues are from the Treasury and reflect assumptions made on a particular pattern of capital formation, growth, inflation, interest rates, and dividends. They do not allow for feedback effects.

[2] See The White House, A Program for Economic Stability, February 1981.

[3] Recent analyses of the Treasury (Treasury 1) tax reform proposals of November 1984 have stressed the allocative inefficiencies of current law, especially as between equipment and plan from the ITC and across asset categories because of the ACRS. See Chirinko-King (1984), Gravelle (1985), Jorgenson-Yun (1984).

[4] Scores of articles and studies evaluating the impacts of business taxes on capital formation appear in the literature. For a review, see Jorgenson (1971) and Sinai-Eckstein (1984).

[5] Chirinko and Eisner (1983) repeat previous criticisms of the Jorgensonian multiplicative variable in studies of the effects of business tax incentives on capital spending in large-scale macroeconometric models. Sinai and Eckstein (1983) respond and refute the methodology and results obtained by Chirinko-Eisner. See also the important paper by Eisner and Nadiri (1968.

[6] Eisner (1978).

[7] Feldstein and Foot (1971).

[8] Coen (1971), Brimmer and Sinai (1976), Sinai (1979), and Sinai and Eckstein (1983) stress the role of cash flow in business fixed investment; Coen through impacts on the speed of adjustment and Sinai through a "financial risk" determinant of capital spending--the ratio of debt service on outstanding indebtedness to cash flow.

[9] See the discussion in Jorgenson-Yun (1984).

[10] Full model simulations of the impacts from 1986 forward are not yet available. In particular, the analysis held constant the effect from the increased consumer demand that might arise from the tax proposals, this overstates the negative impacts on business fixed investment in the full system simulations.

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Appendix

The following regression equations are used in the Shearson-Lehman Brothers Model to determine nonresidential fixed investment.

IPDENR72 = real (1972 dollars) nonresidential equipment investment.

ICNR72 = real (1972 dollars) nonresidential structures investment.

KNPDENR72 = real (1972 dollars) stock of nonresidential equipment.

KNCNR72 = real (1972 dollars) stock of nonresidential structures.

KOYCKCUEXP80 = Expected rate of capacity utilization.

NFCXNFC = debt service burden variable: ratio of interest charges to cash flow.

LETOUTPUTPABE = private sector real output of goods excluding pollution abatement equipment.

PGNP = GNP price deflator

IPDENRCOST = User cost of capital for equipment.

ICNRCOST = User cost of capital for structures.

(1) IPDENR72 = 13.716 -.0303 KNPDENR72 (-1)
(1.09) (.0175)

+.333 KOYCKCUEXP80 (-1)·KNPDENR72 (-1)
(.02)

-15.4 PDL (NFCXNFC) (-1) (2, 5, FAR)
(3.96)

+.445·PDL [LETOUTPUTPABE - LETOUTPUTPABE (-1)] (1, 5, FAR)
(.062)

+76.9 PDL [(PGNP/IPDENRCOST) - [PGNP (-1)/IPDENRCOST (-1)] (2, 13, BOTH)
(6.77)

$\bar{R}^2$=0.991 DW = 0.514

SER = 2.94 Period of Fit 1959:1 to 1984:4

OLS

(2) ICNR72 = -.0563·KNCNR72
(0.35)

+.127·KOYCKCUEXP80 (-1)·KNCNR72 (-1)
(.0317)

Senator RIEGLE. I understand and I appreciate your saying that. But I guess what I'm saying is, I think anything that any of the other speakers can provide that's tangible and that shows gains, is something that we need to work with.

Mr. MACK. Senator, when people beat up on what you did in 1981 and say you were too generous, I think it's important that they be specific. Because when you look at equipment, the improvements in depreciation between pre-1981 and what you did in 1981, is not all that much—at least for assets, which had an ADR midpoint of 14 years or less.

What I'm suggesting is that there was very, very, very substantial improvement in depreciation for long-lived equipment, which there should have been. And for real estate.

I think that you're seeing the results of that, up and down K street and around the beltway, out in McLean, and Tyson's Corner, where our office is. In other words, I think you've got to be specific about where the real benefits of what you did in 1981 are.

They were not all that much in terms of the kind of equipment we make and the customer base we serve uses.

Senator RIEGLE. Maybe what we need then is to actually go further and not reverse directions, which some of you are recommending now. But, maybe we ought to have even a 100-percent writeoff in the first year, or a much faster writeoff, life, on certain kinds of manufacturing assets that are in the areas where we are getting battered the most in our international trading accounts.

In other words, if we want to become competitive and lower the costs of manufacturing, of capital, retain those jobs, and that part of the economic sector of our country, it seems to me that we may have to move in the direction of even faster writeoffs—if that's what the rest of the world is doing.

I'm thinking particularly of Japan. They've got an enormous cost of capital advantage on us. They've just lowered the interest rates again. So you can borrow money at 4 percent in Japan, in addition to all the other economic advantages. It's awfully hard for me to see how any worker or any company here in the United States is going to be able to continue to improve at a faster rate to offset those dollar costs.

I just don't see how we're going to do that.

JAPAN IS IMPROVING ITS DEPRECIATION PROGRAM

Mr. MACK. Japan, by the way, Senator—and I'll supply this for the record—is talking about improving their depreciation program so they can become more competitive with the United States.

[The following information was subsequently supplied for the record:]

PAN ECONOI

INTERNATIONAL WEEKLY
THE NIHON KEIZAI SHIMBUN

1985, Nihon Keizai Shimbun, Inc.

TO MAINTAIN INDUSTRIAL COMPETITIVENESS

Ministry mulls faster depreciation of equipment

More rapid depreciation of industrial equipment is being considered by the Ministry of International Trade and Industry. The ministry fears that unless faster depreciation is adopted for Japanese manufacturers, they will lose out to their American counterparts in the race to modernize machinery and equipment.

According to the ministry's plan, the statutory useful life of industrial plants and equipment would be cut by a uniform 10 per cent to make possible faster tax-exempt depreciation by Japanese companies. The ministry wants this idea to be taken up by the Government's Tax System Council, which will soon begin deliberating on medium- and long-term reform of Japan's tax system.

Statutory Useful Life of Selected Plants and Equipment

(U.S.)		(Japan)	
Automobiles	3 years	Small passenger cars	6 years
		Small trucks	5
Machinery, equipment and parts	5	Automobile manufacturing equipment	10
		Printing plant	10
		Industrial and consumer electronics manufacturing equipment	11
		Oil refining facilities	8
		Steelmaking facilities	14
Elevators	10	Elevators	17
Buildings	15	Wooden houses	24
		Steel frame office buildings	65

A wholesale review of the legally set useful life of industrial equipment, whereby manufcturers determine how fast they replace their facilities, would be the first in 21 years.

The absence of any shortening in the useful life for such a long time has put some Japanese industries at a competitive disadvantage compared with their foreign counterparts, particularly in the U.S., the ministry maintains.

According to the ministry's surveys, most of Japan's semiconductor manufacturers, for example, have opted for taxable depreciation of their equipment after two to three years of use because the equipment would become obsolete if left to age five years, which is the statutory useful life.

As the U.S. Government is taking policy measures to quicken the useful life of industrial equipment used by American manufacturers in an attempt to boost their international competitiveness, the ministry is afraid that unless Japan does the same, American companies will come to have more modern and advanced machinery and equipment than their Japanese competitors in the very near future.

The ministry also is considering raising the percentage of equipment value depreciable within the statutory useful-life period. The percentage now stands at 90 per cent of the purchase price of the equipment. Of the remaining 10 per cent of the purchase value, 5 per cent is depreciable after the elapse of the useful life. The ministry plans to increase the total depreciable ratio to at least 95 per cent in keeping with the pattern of other industrialized countries.

ACTION PROGRAM — The second installment of the Action Program for Improved Market Access is printed on Page 5.

Mr. MACK. I assume I talk for most of the people at the table when I say that if you wanted to do away with all the depreciation schedules and investment tax credits, and provide expensing for productive capital equipment, I suspect most of us up here would say, "fine, we're ready."

Senator RIEGLE. I'm sure you would. I guess what I'd like to be able to do is go the next step and see what we get if that happened.

Obviously, we've got a flow of revenue into the Government. Also we have, in terms of the rate of technological turnover——

Mr. MACK. One thing I would refer you to, Senator, is a couple of charts that were in our testimony that show specifically how rates of growth and real GNP have essentially gone up when the investment tax credit has been in place, and gone down when it hasn't.

The same thing is true of rate of productivity changes.

Senator RIEGLE. Let me quickly move to two other areas because we're going to run out of time here. The merchandise trade deficit is now $148.5 billion, which is just a horrendous number. What's beginning to worry me is the fact that we've just moved into a debtor nation status. As I look at the estimates at the New York Federal Reserve Board, we may be a net debtor nation of somewhere between $500 billion and $1 trillion by 1990. That's 4 years from now.

So it's not only our income statements, trading account, that's in very bad shape but our balance sheet. I'm just wondering if you think this is an urgent problem, the trade deficit and the deterioration of our financial position connected to that.

If you think that's a very serious problem, will these tax changes that have been suggested here, the ones you've been commenting on today, affect that trade deficit and how are they likely in turn to affect our debtor nation status, which we now sadly have, in terms of our standing in the world.

Maybe we could start with you, Mr. Clark.

Mr. CLARK. Yes, Senator. You know, that's a very good point and very relevant. Clearly, the proposals will dampen U.S. exports and they do it in two ways.

One, they raise the cost of credit.

Two, the denial of foreign tax credits for withholding tax is such that we will no longer be able to lend to the U.S. exporter or the foreign borrower who buys U.S. exports, which is a big part of our business and a big part of U.S. exports.

We're going to have to withdraw from that market because of the proposed withholding tax treatment in the House bill. The citizen abroad buying U.S. goods is going to have to rely on financing from the Japanese banks—or other foreign banks—because the American banks aren't going to be in there.

And, you know, this would be a tremendous coup for the Japanese mercantilist approach. You know, they're going to throw their credits toward these buyers of Japanese goods, so you're going to get a very big effect there as we withdraw from the field of financing U.S. exports and leave it to the Japanese banks, because they get full foreign tax credits for withholding taxes they pay and that's very favorable to them.

Mr. HOSTETLER. Certainly, as all of us have commented from the industrial sector, the investment tax credit and R&D credit changes in the proposed bill would hurt the trade deficit rather significantly. And, surely, substituting in terms of the subject of raising revenue, substituting a consumption tax can be structured to aid our trade deficit problem, as the Europeans have very effectively done.

In other words, I think there are several associations that are working on some specifics of a consumption tax proposal that gets to Senator Proxmire's earlier comments about how do we make that fair, and so on. How do we reduce the degree to which it's regressive, and so on.

Senator GORTON. Excuse me. We have a rollcall at this point.

Senator Heinz.

STATEMENT OF SENATOR JOHN HEINZ

Senator HEINZ. Mr. Chairman, I am grateful to the committee for these additional hearings on tax reform. The tax reform measure has far reaching implications for all Americans, and it is only fitting that the Congress hold extensive hearings on it.

As a member of the Finance Committee, I am familiar with many of the concerns being voiced by our witnesses here today and I share their concerns. Of particular interest to me will be our guests' thoughts on the proposed elimination of the investment tax credit [ITC] and the proposed changes to the accelerated cost recovery system [ACRS]. Our examination of these two proposals in the Finance Committee has lead me to oppose the house bill's provisions with respect for both.

A keystone of President Reagan's economic recovery and growth program of 1981 was the reduction of the existing disincentives for business investment through adoption of an accelerated cost recovery system and the liberalization of the investment tax credit. As the Senate sponsor of the original capital Cost Recovery Act, the so-called 10-5-3 bill, I was pleased that the administration strongly advocated changes in the cost recovery system which it believed would increase business investment in plant and equipment and, thereby, increase productivity, economic growth and employment. We in Congress enacted the new system of cost recovery because we shared the concern expressed by economists of both the left and right over the low rate of capital formation and productivity growth in the United States, and the conviction that the complex and too restrictive capital cost recovery system then in place was the major contributing factor.

ACRS and the ITC have begun to achieve precisely what proponents said they would. First, business savings have increased dramatically. Business fixed investment has growth since the last recession at a rate more than double that in previous recoveries. Analysts in the Congressional Budget Office, the Federal Reserve Bank of St. Louis, and elsewhere are concluding that the current strength of business investment can be traced to a combination of the drop in the inflation rate and the enactment of ACRS and liberalization of the ITC, which increased both the after-tax rate of return on new investment and the cash flow that businesses need to finance that investment.

Second, the high rate of business investment has not only led and sustained the business recovery, it also has contributed to antiinflationary increases in plant capacity. Furthermore, the new business investment is concentrated in modern, efficient, state-of-the-art equipment. This modern equipment will help greatly to increase U.S. productivity and international competitiveness in the years ahead.

Third, the double taxation of corporate saving has been substantially reduced by the enactment of ACRS and the liberalization of the ITC which approximates the immediate writeoff of many fixed business assets. Corporate saving can be taxed twice, first when income is earned, and a second time when taxable stockholders receive their dividends. ACRS and ITC together are especially attractive means of reducing this double taxation because they automatically direct a big part of the untaxed savings into the new plants and equipment that support long-term growth and productivity.

The Ways and Means Committee's tax bill (H.R. 3838) eliminates the investment tax credit and replaces ACRS with a decelerated cost recovery system. The proposal, in effect, penalizes investment in capital equipment. This is questionable tax policy for several reasons.

First, there is a continuing need for capital formation. Recent economic gains have not obviated the need for sustained higher levels of business fixed investment, which was widely accepted when ACRS was enacted and the ITC was liberalized. Investment is needed to improve productivity and enable U.S. businesses to compete effectively in the worldwide economy, particularly now, with the overvalued dollar and aggressive foreign competition producing record trade deficits.

Second, ACRS and the ITC support the process of technological innovation. Knowledge produced by research and development must be translated into new and commercially viable products and processes. This frequently requires investment in modern plants and equipment.

Third, at a time of concern over the loss of American jobs and the substantial trade deficit, H.R. 3838 proposes that the United States adopt a cost recovery system that is less favorable than those of our principal trading partners and that would provide a positive incentive for American companies to move their manufacturing operations to Canada, Mexico, or offshore, while selling their products here with the benefits of lower tax rates on taxable income. This is more than a theoretical concern. Countries such as Canada have promoted the movement of manufacturing operations to their soil with descriptions of their more favorable cost recovery systems.

ACRS and the ITC are broad-based, efficient incentives available to all businesses on a broad range of qualified assets. Unlike more general tax relief, their benefits cannot be dissipated because they require an affirmative act of investment in the domestic economy. In enacting ACRS and the ITC, our policy was intentionally to change resource allocation, restrain consumption, and enhance capital formation. The record shows that we are succeeding. The elimination of the ITC and the changes to the ACRS contained in H.R. 3838 would be a retreat from our long-standing bipartisan policy of promoting a growth-oriented, industrial nation with high paying jobs at home and competitiveness abroad.

Although the ITC and ACRS proposals are of primary concern to me, our hearings today will also focus on H.R. 3838's proposals to eliminate the deduction for loan loss reserves for large banks, to change the treatment of foreign tax payments for certain financial institutions, to tax employee benefits and many others. A multitude of areas of American life are affected by the Ways and Means Committee's tax reform bill. I am concerned about the effects of all of these proposals and I welcome the views of our guests today.

Senator GORTON. Senator Cranston, it's your turn. I think, when you finish, we'll simply recess the hearing. If you want them to come back, tell them to do so; otherwise, we'll go on to the next panel.

Senator CRANSTON. Thank you very much, Mr. Chairman. I'll have to be brief because I've got to make that rollcall and I cannot come back.

Let me just put one general question to whoever chooses to answer.

TAX FAIRNESS

I've held about 50 community forums in the past months on various issues, and virtually all of them touched on tax reform. While many people in California share your skepticism about changes in the Tax Code which increase the cost of capital to vital industries, many other people are upset over the results for taxpayers under the present Tax Code.

Some pay more, some pay less on the same amount of income. Some individuals and some corporations pay no Federal income taxes despite millions or billions in earnings.

If we're going to have support for our tax system, there's got to be a sense that it's fair. What is your recommendation on the fairness issue?

Mr. HUARD. I think that a large part of the problem, Senator, is perception. Senator Proxmire pointed out a figure of $49 billion profits amongst a group of corporations who paid no Federal income tax whatsoever.

The problem there is the validity of the figure of $49 billion. I suspect that that figure of $49 billion was taken from the financial statements of those corporations.

Now, it's a known fact that in financial statements for accounting purposes, things like depreciation and capital expenditures, are done on a nonaccelerated basis over an unrealistically long period of time.

Now this has a gratifying effect in boosting earnings that are reported to shareholders; whether it's a real measure of economic income is another question entirely.

I would suggest that that $49 billion figure would evaporate if you treated capital expenditures like any other cost of doing business and expensed it and wrote it off in the first year—like advertising, labor costs, R&D.

Another factor, and I tend to agree with Barber Conable, the former distinguished member of the Ways and Means Committee, on this issue, is this.

You can have a tax system that's fair or you can have a tax system that's simple. But it's going to be very difficult to have both. As you know, you come from a community property State. The Supreme Court decision back, I guess, in 1948 resulted in a situation where one spouse earning $100,000 and a resident of California is married to another spouse earning zero. They have to pay taxes as though each had an income of $50,000. You then had 10 States paying taxes that way and the other 40 out in left field.

So they put in the joint return system and you had people pointing out that they were single parents and that that was unfair. So then you had head of household rates.

Then you had the marriage penalty, so you got the marriage two-earner income deduction. What happens is, in order to achieve fairness in the progressive tax system, you get all of these encrustations designed to achieve such fairness, but which erode the principle of simplicity.

I would suggest very much that I think what people are reacting to in your community forums is the fact that we have an ungodly complex Tax Code. But I think we would do well to remember that a large part of that complexity was put in there to achieve goals of fairness.

Senator **Cranston**. Yes. I thank you very much.

Senator **Riegle**. I could keep the panel for at least a couple of days.

Senator **Cranston**. Thank you very much.

Senator **Riegle**. I'm going to have some questions for the record, too, in some detail because I really appreciate your willingness to testify today, and I intend to use the material which you're bringing and providing us.

Mr. Clark, I'm going to ask you specifically one other thing, which I'll just mention and then I must excuse myself because I must go vote, too.

You suggested that Chairman Volcker and Treasury Secretary Baker be called to testify here on the implications of H.R. 3838 and the Baker initiative.

I was wondering, and I want you to be as specific as you can be in terms of what you perceive as the negative implications on the lesser developed countries and on the banks. Here, I mean, you've got some pressures within the banking system, which we all know, but what you see coming from this. As we see what's now there carried forward, I'd like to really try to pin that down as a basis for a possible hearing we might have at that time.

Mr. **Clark**. Yes, sir. There are two big deals going on these days. One is the rescheduling of our present outstanding debt, which totals some $400 billion. And I've spent most of the last 3 years, and a lot of other people have, trying to keep this thing from becoming a crisis.

And I must say, Paul Volcker particularly has been effective and active in that. What we do there, Senator, is we get all the banks that have outstandings and we say, you know, you've got to renew those outstandings.

More or less, we've been able to do that because we have kind of a level playing field out there. American banks participate reluctantly because the Japanese banks are also participating, and so on.

Now we'll have a whole new deck of cards because we will no longer be able to claim a credit for the withholding taxes that are collected in the borrowing debtor countries to apply to our United States taxes, even though all other participants—the Japanese, the Germans, the United Kingdom, and other banks—do have and continue to have that opportunity with their own governments to claim these credits against their own local taxes.

Senator **Riegle**. Let me just interrupt you this minute. I have been told if I don't leave this minute I miss this vote.

But I would like you, if you would, to continue your response until you have completed it so that we can have a complete response on the record now. Then I will suggest that we consider that the conclusion of this panel, and when Senator Gorton comes back we will proceed with the next panel.

But I thank all of you and appreciate the time you have taken with the questions that I will be submitting for the record.

Senator **Riegle**. Please finish your answer.

POSSIBLE GLOBAL DEBT CRISIS

Mr. **Clark**. What will specifically happen there is that the U.S. banks, who are already participating but are participating reluctantly, will have an absolutely perfect excuse to drop out because they will say that either these loans on an after-tax basis are actually losers or the earnings on them are so narrow because of the double taxation which will result that they can no longer afford to keep them on the books, and there you will have about $150 billion of lenders trying to withdraw from this local debt structure that we now have.

Now, the second point was that we hoped we were moving to a more positive phase of this effort, and that is the offering of the new loans under the Baker initiative, which was a very timely positive effort. But there is no way that we are going to be able to go back to the American banks and ask them to put up new money under the Baker initiative when the earnings on those loans will be negative or will be minimal.

So my basic question there is: Where is Mr. Volcker, and where is Mr. Baker?

I think they both would have very relevant things to say about this issue, which is, you know, we are talking about the global debt crisis. We are trying to avoid it, and H.R. 3838 drives us substantially closer to it.

[Recess.]

Senator **Hecht** [presiding]. We will reconvene the Senate Banking Committee for the hearing on the implications of H.R. 3838, the Tax Reform Act, in the areas of the committee's jurisdiction.

Because of the time constraint, without further ado we will start off with Mr. Lowell Beck, president, National Association of Independent Insurers from Illinois.

STATEMENT OF LOWELL R. BECK, PRESIDENT, NATIONAL ASSOCIATION OF INDEPENDENT INSURERS, DES PLAINES, IL

Mr. BECK. Mr. Chairman, thank you for this opportunity to appear before you.

I am Lowell Beck, president of the National Association of Independent Insurers [NAII].

The NAII is a voluntary association representing nearly 500 property and casualty insurance companies throughout the country. We are an organization that has members of all sizes, some very large, and some of the smallest, one-State and regional companies. We have all different structures. There are stock companies, nonstock companies, and companies with different delivery systems.

The testimony I am giving today represents only the views of the NAII and does not represent the views of other property and casualty trade associations.

The Reinsurance Association of America has asked that they be associated with these remarks. It is my understanding that various other associations may be filing statements for the record.

By way of background, the property and casualty insurance industry, at the request of the House Ways and Means Committee, agreed to develop a revenue proposal which would provide substantial tax reform for the industry while meeting increased revenue needs the committee felt were necessary from property and casualty insurers.

INSURANCE INDUSTRY SHOULDERS ITS SHARE OF THE TAX BURDEN

Section 1021 of H.R. 3838, known as the revenue offset proposal, is the result of that effort by the property and casualty insurance industry and is supported by the entire property and casualty industry.

It provides that 20 percent of the unearned premium reserves be phased in over a 5-year period as income for tax purposes of a property/casualty insurance company. This is a reform of current insurance tax policy. It is a reform that had been recommended, as a matter of fact, by the General Accounting Office.

The industry came forward with this provision to demonstrate its willingness to contribute more tax revenues than under the current system.

The sections of concern to the NAII which might fall within the jurisdiction of the Banking Committee are sections 1022 and 1027 of H.R. 3838.

Section 1022 provides for taxation of certain dividends and tax-exempt interest. The property/casualty industry relies on investment income to help pay losses when premiums are inadequate to do so. Many companies within this industry are heavy investors in municipal bonds, and this industry is the second largest institutional purchaser of State and municipal bonds.

The industry believes that it is unfair to restrict its investment in tax-exempt obligations while others are permitted to hold these types of investments without the imposition of a tax.

The NAII does not believe that this provision provides a revenue gain and could even result in a loss of revenue by shifting the ownership of these types of obligations to high bracket individuals in search of income shelters.

We believe that such a tax could cause competitive distortions in the property and casualty insurance industry, since some companies hold substantial portfolios of exempt obligations while others do not.

A tax based on interest from newly acquired exempt securities, which is the case now in the House bill, would permit companies now holding tax-exempt securities to keep them tax-free while in effect freezing out other companies that might wish to purchase new issues of this form of investment, thereby causing competitive distortions.

We further believe that such a tax would result in increasing premiums, particularly in liability lines, where insurance coverage is already difficult to obtain. To the extent that imposing a tax on property and casualty companies based on their interest on municipal obligations results in an increased cost to those companies, they will be forced to reflect those increased costs in the form of additional premium increases.

Because significant amounts of exempt obligations are held to fund reserves on long-tail liability lines, it can be anticipated that premium increases in these lines would be substantial.

Given the fact that under current market conditions these premiums are already undergoing substantial increases, to the point that many businesses, municipalities, school districts, and others are being priced out of the market, it is likely that the ability to obtain insurance coverage will be restricted even further because of this particular provision relating to municipal bonds.

Section 1027 provides for a study by the Treasury Department and the Joint Committee on Taxation on the treatment of loss reserves of property and casualty insurance companies.

We believe that one of the purposes of this study would be to revise the so-called qualified reserve account, or the QRA as it is commonly known, variations of which were proposed in the administration's early tax reform drafts and the General Accounting Office report.

The property/casualty insurance industry strongly opposes the imposition of a new accounting system which will seriously undermine the financial integrity of State regulation of insurance and the operating framework of the property/casualty insurance industry for solvency purposes.

The QRA proposal was the subject of earlier tax hearings, and following this extensive testimony, there virtually was no support for this particular proposal in the House Ways and Means Committee, and the Senate Finance Committee.

And so, while there is a study of discounting reserves in the House bill, we believe that this is no longer required, particularly in view of the GAO study that has gone on now for the last couple of years.

That concludes my statement, Mr. Chairman. We very much appreciate the opportunity to be here.

[The complete prepared statement follows:]

STATEMENT OF
LOWELL R. BECK, PRESIDENT
NATIONAL ASSOCIATION OF INDEPENDENT INSURERS
BEFORE THE
BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE
UNITED STATES SENATE
FEBRUARY 4, 1986

My name is Lowell R. Beck and I am President of the National Association of Independent Insurers (NAII).

NAII is a voluntary national trade association of nearly 500 property and casualty insurers. Our organization provides a truly representative cross section of the property and casualty insurance business in America. Our members range in size from the smallest one-state companies to very large national underwriters, and consist of both stock and non-stock companies. NAII member companies reflect all forms of merchandising -- independent agency, exclusive agency, and direct writers; and they include insurers which serve a general consumer market and those which specialize in serving particular consumer groups such as farmers, teachers, government employees, military personnel, truckers and credit unions.

The testimony I am giving today represents the views of NAII and does not represent the views of other property and casualty trade associations. The Reinsurance Association of America has asked to be associated with these remarks. It is my understanding that the Alliance of American Insurers, the American Insurance Association and the National Association of Mutual Insurance Companies may submit separate views for the record.

By way of background, the property/casualty insurance industry at the request of the House Ways and Means Committee, agreed to develop a revenue proposal which would provide substantial tax "reform" for the industry while meeting the increased revenue needs the committee felt were necessary from property/casualty insurers. Section 1021 of H.R. 3838, the revenue offset proposal, is the result of that effort and is supported by the industry. It provides that 20 percent of the unearned premium reserves be phased in over a five-year period as income for tax purposes of a property/casualty insurance company and is a "reform" of current insurance tax policy. The 20 percent figure can be adjusted upward if revenues are insufficient. Industry support for this provision demonstrates a willingness to contribute more tax revenues than under the present system.

The sections of concern to NAII and which might fall within the jurisdiction of your committee, are Sections 1022 and 1027 of H.R. 3838.

Section 1022 provides for taxation of certain dividends and tax-exempt interest. The property/casualty insurance industry relies on investment income to help pay losses when premiums are inadequate to do so and is the second largest purchaser of state and municipal bonds.

We think it is unfair to restrict our investment in tax-exempt obligations while others are permitted to hold these types of investments without the imposition of a tax. We do not believe this provision provides a revenue gain and could result in a loss of revenue by shifting the ownership of these types of obligations to high-bracket individuals in search of income shelters.

We believe such a tax could cause competitive distortions in the property and casualty insurance industry since some companies hold substantial portfolios of exempt obligations while others do not. A tax based on interest from newly acquired exempt securities would permit companies now holding those securities to keep them while, in effect, freezing other companies out of that form of investment, thereby causing competitive distortions.

We further believe such a tax would result in increasing premiums, particularly in liability lines where insurance coverage is already difficult to obtain. To the extent imposing a tax on property and casualty companies based on their interest on municipal obligations results in an increased cost to those companies, then they will be forced to reflect those increased costs in the form of premium increases.

Because significant amounts of exempt obligations are held to fund reserves on long-tail liability lines, it can be anticipated that premium increases in those lines will be substantial. Given the fact that under current market conditions these premiums are already undergoing substantial increases to the point that many businesses, municipalities, school districts and others are being priced out of the market, it is not unlikely that the inability to obtain insurance coverage will be even further restricted.

Section 1027 provides for a study by the Department of the Treasury and the Joint Committee on Taxation, of the treatment of loss reserves of property/casualty insurance companies. We believe the purpose of this study is to revise the so-called "Qualified Reserve Account" or QRA, variations of which were proposed in the Administration's early tax reform drafts and the General Accounting Office report. The property/casualty insurance industry strongly opposes the imposition of a new accounting system which will seriously undermine the financial integrity of state regulation and the operating framework of the property/casualty insurance industry for solvency purposes. The QRA proposal was the subject of earlier tax hearings. Following industry testimony against it, there virtually was no support for the proposal in the House Ways and Means and Senate Finance Committees. We see no need to again "study" a proposal which has already been discredited.

We very much appreciate this opportunity to present some of our concerns with H.R. 3838.

Senator HECHT. Thank you very much.

Mr. Thomas Maletta, vice president—taxes, Household International Corp. of Prospect Heights, IL. Please proceed.

STATEMENT OF THOMAS P. MALETTA, VICE PRESIDENT—TAXES, HOUSEHOLD INTERNATIONAL, INC., PROSPECT HEIGHTS, IL, REPRESENTING THE AMERICAN FINANCIAL SERVICES ASSOCIATION

Mr. MALETTA. Mr. Chairman, I am Thomas P. Maletta, vice president—taxes, for Household International. I am testifying today on behalf of the American Financial Services Association [AFSA], which is the national trade association of financial service companies.

AFSA represents over 500 companies, operating more than 11,000 offices, serving the public throughout the country.

AFSA membership is highly diversified, ranging from single consumer finance offices to national delivery companies engaged in unsecured direct lending, second mortgage lending, consumer banking, industrial banking, and the financing of the sale of durable goods.

We appreciate the opportunity to appear before you today to present the view of the American Financial Services Association on those issues raised by H.R. 3838.

RESERVE METHOD OF ACCOUNTING FOR BAD DEBT DEDUCTIONS

The first issue I would like to discuss is the proposal to repeal the reserve method of accounting for bad debt deductions and to require that the balance in any reserve account for bad debts as of the effective date be taken back into taxable income ratably over a 5-year period.

Present law permits taxpayers a deduction for bad debts arising from a trade or business which becomes wholly or partially worthless during the taxable year. The deduction amount may be determined using either the specific chargeoff method or the reserve method.

Under the specific chargeoff method, a deduction is allowed for bad debts as the individual debt becomes either wholly or partially worthless. The debt is not considered worthless as long as there is a reasonable expectation that it may eventually be paid.

The reserve method, on the other hand, allows a deduction for a reasonable addition to a reserve account set up as an allowance against the eventuality that some receivables may later prove to be uncollectible.

The most widely used formula for determining the amount of reserve appropriate for tax purposes is known as the Black Motor formula. This uses a moving average of bad debts actually charged off over the most recent 6-year period.

The result is an experience-based estimate of the bad debt charge offs to occur in that particular taxable year. It should be noted that even if the Black Motor formula is used the result obtained must still be reasonable under the circumstances of the year of computation.

The members of AFSA oppose H.R. 3838's treatment of bad debt reserves for the following reasons:

Too many factual problems exist in determining the exact moment a debt becomes worthless.

The bill seems to recognize this fact by allowing a taxpayer to deduct the bad debt in the year in which he discovers it to be worthless, even if the worthlessness occurred in a prior year. This, however, is an inadequate remedy for the many debts which are worthless well before they can be proved worthless.

The reserve method also results in a proper matching of expenses and income. Under the specific chargeoff methods, loans receivable are always and will be overstated because unknown bad debts cannot be accounted for on a current basis.

When a portfolio of loans is made, the percentage which will not be repaid can reasonably be estimated, and this represents a realized credit loss. If the income and certainty of credit losses in a portfolio are reasonably known by proven experience, it is our opinion that it is appropriate to recognize the loss ratably over the life of the loan rather than waiting until the eleventh hour.

The proposal to take into income over a 5-year period the balance in any bad debt reserve account would serve to further overstate taxpayers' income during the 5-year transition period.

Moreover, it is certainly more onerous than the 10-year spread forward generally available for other accounting method changes.

This committee is well aware of the serious difficulties numerous financial institutions around the country are experiencing as a result of loan defaults. It is ironic that this particular proposal would exacerbate these difficulties.

DEDUCTIBILITY OF CONSUMER INTEREST PAYMENTS

We are also concerned, Mr. Chairman, about the deductibility of consumer interest payments. Under present law no limitation is imposed on the deductibility of interest incurred to purchase or carry consumption goods. Under the tax shelter provisions of the bill the deduction for all nonbusiness interest is limited to the sum of net investment income and $10,000 for single filing taxpayers and $20,000 in the case of a joint return.

The members of AFSA understand the interest of Congress in limiting the deductibility of interest expense incurred to acquire or carry tax-sheltered investments. We feel, however, that it is inappropriate to include consumer interest such as interest paid or incurred to purchase an automobile for personal use within the broadly cast tax shelter nets.

We believe a more directed approach should be taken with respect to tax shelter abuses so as to limit the effects of this area of tax reform to tax shelter activities without having them spill over into consumer purchasing, where they may adversely affect other sectors of the economy.

The Economic Recovery Tax Act of 1981 included specific provisions intended to provide relief to acquirers of financially troubled thrift institutions.

H.R. 3838 would repeal those rules which provided that gross income of a domestic building and loan association does not include any amount of money or other property received from the FSLIC, and it would also provide that the domestic building and loan association does not reduce its basis of assets or other property received from the FSLIC and that the merger of an insolvent thrift institution into a solvent thrift institution may qualify as a tax-free reorganization so that various tax carryover attributes would then incur to the purchaser.

The stated purpose of these special rules in the 1981 act was to provide favorable tax rules to aid financially troubled thrift institutions, their depositors, and the institutions that insure their deposits.

We believe, in light of the seemingly ever increasing number of financially troubled thrift institutions and the feared inadequacy of the FSLIC reserves, that the purposes of the 1981 act are every bit as valid today as they were in 1981.

The 1981 act provided an incentive to solvent thrift institutions and other private industries to acquire troubled S&L institutions which might not survive without an infusion of capital and management.

We feel this serves the interests of the thrift community in limiting the number of defaults, with their potential cost to the FSLIC and the loss of depositor confidence.

In addition, such acquisitions, whether or not contemplated or accompanied by FSLIC payments, are undoubtedly cost effective to the FSLIC and the U.S. Treasury as a whole.

In short, it is our experience that the provisions work well and serve the purposes for which they were established.

The last point I would like to make, Mr. Chairman, is with respect to foreign tax credit.

The bill provides that all interest expense of an affiliated group of corporations are to be allocated as if all members of the group were a single corporation. When interest expense incurred by a U.S. corporation is allocated to affiliated foreign companies in operations, the expense reduces the amount of net foreign source income from the foreign operation. This in turn has the effect of reducing the amount of foreign tax credit that is available for those operations as an offset against U.S. tax.

If the amount of U.S. source interest expense which is arbitrarily allocated to the foreign source income reduces net income to zero, no foreign tax credit is available with respect to those earnings of foreign operations.

The bill appears to recognize, however, that financial institutions incur huge amounts of interest expense by their very nature and that this expense may not relate to the funding of foreign activities of other members of the affiliated group.

Accordingly, the bill excepts from the single corporation rule banks and savings institutions as defined in sections 581 and 591 of the Internal Revenue Code. However, nonbank financial services are not accorded this same treatment.

In effect, under the bill, if a finance corporation is a member of an affiliated group of corporations which includes foreign operations, the group will forgo all foreign tax credit benefits. The parent corporation of such a group would undoubtedly consider disposing of either the finance corporation or its foreign operations inasmuch as the permanent loss of foreign tax credits would drive up the effective tax rate on foreign income to 75 to 90 percent of its pretax income.

We see no valid reason for distinguishing between banks, savings institutions and finance corporations where the latter's business; that is, the finance corporations, principally consist in dealings with unrelated third parties and customers.

This is certainly inconsistent with the level playing field concept often heard when the reasons for tax reform are expressed.

Again, Mr. Chairman, I would like to very much thank the chairman for giving us the opportunity to express some of the concerns of AFSA with respect to H.R. 3838.

[The complete prepared statement follows:]

STATEMENT OF

THE AMERICAN FINANCIAL SERVICES ASSOCIATION

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

H.R. 3838

FEBRUARY 4, 1986

Mr. Chairman and Members of the Committee, I am Thomas P. Maletta, Vice President-Taxes for Household International, Inc. I am testifying today on behalf of the American Financial Services Association, the national trade association of financial services companies. AFSA represents over 511 companies operating more than 11,700 offices serving the public throughout the country. AFSA membership is highly diversified ranging from single consumer finance offices to national delivery companies engaged in unsecured direct lending, second mortgage lending, consumer banking, industrial banking and the financing of the sale of durable goods.

I appreciate the opportunity to appear before you today to present the view of the American Financial Services Association on those issues raised by H.R. 3838 which are of concern to the AFSA membership and impact on areas within the Banking Committee's jurisdiction.

Bad Debt Reserve Method:

The first issue I would like to discuss is the proposal to repeal the reserve method of accounting for bad debt deductions and to require that the balance in any reserve for bad debts as of the effective date be taken into income ratably over a five-year period.

Present law permits taxpayers a deduction for debts arising from a trade or business which become wholly or partially worthless during the taxable year. The deduction amount may be determined using either the specific charge-off method or the reserve method.

Under the specific charge-off method, a deduction is allowed for bad debts as the individual debt becomes either wholly or partially worthless. The debt is not considered worthless as long as there is a reasonable expectation that it eventually may be paid.

The reserve method allows a deduction for a reasonable addition to a reserve account set up as an allowance against the eventuality that some receivables may later prove to be uncollectible. The most widely used formula for determining the amount of reserve appropriate for tax purposes is known as the Black Motor formula and uses a moving average of bad debts actually charged off for the most recent six years. The result is an experience based estimate of the bad debt charge-offs to occur in the taxable year. It should be noted that even if the Black Motor formula is used, the result obtained must still be reasonable under the circumstances of the year of computation.

The members of AFSA oppose H.R. 3838's treatment of bad debt reserves for the following reasons:

1. Too many factual problems exist in determining the exact moment a debt becomes worthless. The bill seems to recognize this fact by allowing a taxpayer to deduct the bad debt in the year in which he discovers it to be worthless, even if worthlessness occurred in a prior year. This is an inadequate remedy for the many debts which are worthless well before they can be proved worthless.

2. The reserve method results in a proper matching of expenses and income. Under the specific charge-off method, loans receivable are always overstated, because unknown bad debts are not accounted for.

3. When a portfolio of loans is made, the percentage which will not be repaid is reasonably estimative and represents a realized credit loss. If the amount and certainty of credit losses in a portfolio are reasonably known by proven experience, it is appropriate to recognize the loss.

4. The proposal to take into income over a five-year period the balance in any bad debt reserve account would serve to further overstate taxpayers' income during the five-year transition period. It is certainly more onerous than the ten-year spread forward generally available for other accounting method changes.

This Committee is well aware of the serious difficulties numerous financial institutions around the country are experiencing as a result of loan defaults. It is ironic that this particular proposal would exacerbate these difficulties.

Deductibility of Consumer Interest Payments:

Under present law, no limitation is imposed on the deductibility of interest incurred to purchase or carry consumption goods. Under the tax shelter provisions of the bill, the deduction for all non-business interest is limited to the sum of (1) net investment income and (2) $10,000 ($20,000 in the case of a joint return).

The members of APSA understand the interest of Congress in limiting the deductibility of interest expense incurred to acquire or carry tax sheltered investments. We feel, however, that is it inappropriate to include consumer interest, such as interest paid or incurred to purchase an automobile for personal use, within the broadly cast tax shelter net.

We believe a more directed approach should be taken with respect to tax shelter abuses so as to limit the effects of this area of tax reform to tax shelter activities without having them spill over into consumer purchasing where they may adversely affect other sectors of the economy.

Reorganizations of Financially Troubled Thrift Institutions:

The Economic Recovery Tax Act of 1981 included special provisions intended to provide relief to financially troubled thrift institutions. H.R. 3838 would repeal these rules which provide that (i) gross income of a domestic building and loan association does not include any amount of money or other property received from the FSLIC, (ii) the domestic building and loan association does not reduce its basis of assets as a result of money or other property received from the FSLIC, and (iii) the merger of an insolvent thrift institution into a solvent thrift institution may qualify as a tax free reorganization.

The stated purpose of these special rules in the 1981 Act was to provide favorable tax rules to aid financially troubled thrift institutions, their depositors, and the institutions that insure their deposits. We believe, in light of the seemingly ever increasing numbers of financially troubled thrift institutions and the feared inadequacy of FSLIC reserves, the purposes of the 1981 Act are every bit as valid today as they were in 1981.

The 1981 Act provides an incentive to solvent thrift institutions to acquire troubled savings and loan institutions which might not survive without an infusion of capital and management. We feel this serves the interests of the thrift community in limiting the number of defaults, with their potential cost to the FSLIC and the loss of depositor confidence. In addition, such acquisitions, whether or not accompanied by FSLIC payments, are undoubtedly cost effective to the FSLIC and the U.S. Treasury as a whole. In short, it is our experience that the provisions work well and serve the purposes for which they were established.

Foreign Tax Credit:

Under present law, the overall foreign tax credit limitation is calculated separately for DISC dividends, FSC dividends, taxable income of a FSC attributable to foreign trade income, and passive interest income. The bill would eliminate the special limitation for passive interest income but add separate limitations for passive income, banking and insurance income, and shipping income. This further complicates an already overly complex series of provisions.

The bill further provides that all interest expenses of an affiliated group of corporations are to be allocated as if all members of the group were a single corporation. When interest expense incurred by a U.S. corporation is allocated to affiliated foreign operations, the expense reduces the amount of net foreign source income from the foreign operation, and this in turn reduces the amount of foreign tax credit from those operations. If the amount of U.S. source interest expense which is allocated to the foreign source income reduces net foreign source income to zero, no foreign tax credit is available with respect to the earnings of the foreign operations.

The bill appears to recognize, however, that financial institutions incur huge amounts of interest expense by their very nature, and that this expense may not relate to the funding of foreign activities of other members of the affiliated group. Accordingly, the bill excepts from the "single corporation" rule, banks and savings institutions as defined in §§581 and 591 of the Internal Revenue Code of 1954. Nonbank financial service companies are not accorded this same treatment. In effect, under the bill, if a finance corporation is a member of an affiliated group of corporations which include foreign operations, the group will forego all foreign tax credit benefits. The parent corporation of such a group would undoubtedly consider disposing of either the finance corporation or its foreign operations, inasmuch as the permanent loss of foreign tax credits would drive up the effective tax rate on foreign income to 75-90% of pre-tax income.

We see no valid reason for distinguishing between banks, savings institutions and finance corporations, where the latter's business consists principally in dealings with unrelated persons and customers. This is certainly inconsistent with the "level playing field" concept often heard when the reasons for Tax Reform are expressed.

I would very much like to thank the Chairman and members of the Committee for giving me this opportunity to express some of the concerns of AFSA regarding the implications of H.R. 3838 to financial services companies.

Senator **Hecht**. Thank you both very much.

Because of the constraints on time that none of us anticipated earlier, I am going to close the hearing now. However, I want to mention that there are going to be many questions from different Senators that will be presented to you for the record, and we would appreciate answers, if possible, by next week or as soon as possible.

The hearing is adjourned.

[Whereupon, at 12:15 p.m., the committee was adjourned until 9:30 a.m. February 5, 1986.]

[Response to written questions of Senators D'Amato, Proxmire, Riegle, and Sasser follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM JAMES H. MACK

Q. 1. In testimony before the Senate Finance Committee last week, former assistant Treasury secretary Paul Craig Roberts stated that the basic problem with H.R. 3838 is that "it raises the marginal tax rates on new investment and uses the proceeds to lower the average tax rate on labor income and on investments already in place."

a. Do you agree with this statement?

b. Does H.R. 3838 effectively raise the cost of capital while weakening the competitive position of U.S. industry abroad? How does the tax bill do this?

A. 1. Mr. Roberts is right on target with his statement. H.R. 3838 substantially raises the cost of capital by reducing investment incentives, thus weakening our competitive position at home and abroad.

Q. 2. The so-called tax reform bill contains provisions that would limit employee accumulation of retirement funds through their employers. Therefore this deferred compensation would be paid as taxable wages.

a. Would this provison have an adverse effect on the process of capital formation because it reduces the capital base for pension funds?

b. If we impede the process of capital formation and thereby increase the cost of capital, don't we make it harder for American industry to become competitive with foreign manufacturers?

A. 2. As I indicated in response to your earlier question, increasing capital costs clearly makes it harder for American manufacturers to become competitive with foreign manufacturers and results in fewer jobs for Americans.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM JAMES H. MACK

Q. Mr. Clark of Citibank expressed concerns on page 2 of his testimony that the foreign tax credit provisions of H.R. 3838, will impede the growth of U.S. exports. Some economists contend that the main reason our exports to Latin America have dropped off is that those countries are using most of their export earnings to pay interest on their debts rather than to purchase new goods. These economists contend that our exporters are suffering so that our banks will not have to take a hit on their balance sheets by writing off some of what appears to be bad debt. Do you agree that there is necessarily a conflict in our debt strategy between what would benefit our exporters as opposed to bank stockholders?

A. I have insufficient knowledge of the subject matter upon which to base an intelligent answer to your question.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM

JAMES H. MACK

Q.1. RE: COSTS OF CAPITAL

You have argued that enactment of H.R. 3838 will substantially increase the costs of capital and thereby push your customer base offshore. What elements of the proposed tax bill will have the most significant effect on decisions to locate plants overseas rather than in the U.S.? What will be the estimated impact on American workers and jobs? What effect does the Reagan tax proposal have upon the costs of capital? Is the impact the same as under the House plan? If you had to choose between the Reagan plan and the House plan, which one would you choose and why?

A. 1. Costs of Capital

The elimination of the 10% Investment Tax Credit (ITC) and the substantial reduction in depreciation allowances, taken together, will increase the cost of capital to American manufacturing industry. This will make it more difficult for American manufacturers to remain competitive through production in the United States. Thus, the trend, already begun, towards sourcing entire product lines or components offshore will be accelerated. As I indicated in my testimony, it doesn't take a genius to figure out the proper course of action, if it's cheaper to make things offshore, bring them into the United States, and pay a lower rate of tax on the profits generated by those sales. The alternative is to continue producing in the United States with reduced productivity (because the cost of productivity improvements will be substantially higher), and see a larger and larger share of your market being eroded by imports (because of the lack of sufficient productivity). In either case, American manufacturing capacity and American jobs will be lost.

The Reagan tax proposal is not substantially different from H.R. 3838, except that depreciation is indexed before inflation. However, there is no substantial improvement for our customer base, until (God, forbid!) inflation hits double digit figures.

Neither the Reagan plan nor H.R. 3838 are acceptable, if one is truly concerned about the competitiveness of American manufacturing industry.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM

JAMES H. MACK

Q.2. James C. Miller,III, the director of the Office of Management and Budget, recently stated in an article in THE WASHINGTON POST on January 28, 1986 that: "If we raised taxes on 'business,' we'd see them passed on to consumers in the form of higher prices or lead to less investment in plant and equipment, and therefore fewer jobs." What is your response to Miller's statement? Since you have argued that the impact of the House bill is to effectively raise taxes, even while it is lowering the maximum corporate tax rate to 36%, will it lead to higher prices, less investment and fewer jobs? How does this compare to President Reagan's tax proposal?

A. 2. Mr. Miller's Question

I agree with Mr. Miller's analysis, as it appeared in the January 28th Washington Post. As I indicated in response to your earlier question both H.R. 3838 and the Reagan proposal will lead to higher prices, less investment and fewer jobs.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SASSER FROM

JAMES H. MACK

Mr. Mack:

Q.1. It is an obvious fact of economic life in the United States that if we are going to sustain our standard of living, we are going to have to reverse the trend in the trade balance, both by meeting the competition in domestic markets and by expanding our export markets. That means maintaining a climate for innovation. It also means promoting fair international trading practices, but I limit my inquiry here to the impact of the tax bill.

U.S. market share of high-technology exports dropped from 30 percent to 24 percent during the 1970s. That was before the skyrocketing interest rates of the early 1980s, and before the value of the dollar rose precipitously against other currencies. Obviously, there was a distortion of worldwide industrial capacities in the years following World War II. And there were going to be adjustments. But we had a trade deficit in 1985 of almost $150 billion. That is more of an adjustment than I am willing to make.

The Banking Committee's focus is on the impact of the tax bill on U.S. export capacity. I would like to have some examples of the impact of taxes on two major areas:

First, what kinds of investments have been made with R&D tax credits in the machine tool industry that will make U.S. products more competitive on world markets? Are these investments primarily in products or in processes? I understand that the benefits of research and development are hard to see at the front end, but where is the major potential?

In your answer, please address one particular concern associated with the R&D tax credit. There have been references in the past to the fact that a well-known fast-food company claimed an R&D tax credit for a new sauce for a particular chicken product. This sauce was in fact a product; it was new and innovative; and it was developed in a laboratory for carrying on trade during a year in which the company increased its R&D above its previous three-year average.

How do you differentiate that from the potential for major developments in science and engineering?

A. 1. R & D Investment

R & D initiatives are essential if the U.S. machine tool industry is to recapture its competitive edge and remain a viable force in world markets. NMTBA strongly supports a permanent retention of the 25% R & D tax credit. It is difficult, however, to identify specific investments which have been made by the machine tool industry as a result of the R & D tax credit. The credit is, as you know, incremental in nature -- the credit acts as a competitive tool which permits machine tool builders to make those R & D investments which, on the margin, would otherwise have been deferred or not made at all.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SASSER FROM

JAMES H. MACK

Recent contacts with NMTBA member companies indicate that many who are operating in a profit mode have made use of the credit since its enactment in 1981. Machine tool R & D efforts have focused largely on the following areas: computer-aided design and manufacturing, materials handling processes and the development of flexible manufacturing systems.

It should be noted, however, that a substantial portion of our membership is and has been operating at a loss and therefore has not been in a position to claim the credit. These companies have indicated their intention to utilize the credit if and when their operations resume at profitable levels.

We appreciate your concern, Senator, regarding alleged abuses of the credit. Both H.R. 3838 and Senate legislation (S. 58) include narrowed definitions of qualified research expenditures which ensure that the credit fulfills the purpose for which it was enacted -- that is, the encouragement of true technological innovation. In this regard, both bills make clear that actitives relating to style, taste, cosmetic or seasonal design factors do not constitute qualified experimentation.

As we noted in our written submission to the Committee, although the industry is responding to the competitive challenges through aggressive cost-cutting and accelerated investment in R & D, it is unquestionably undergoing a period of competitive realignment. By doubling the rate of taxes paid by machine tool makers over the next five years and by significantly increasing the cost of capital purchases by its customer base, passage of H.R. 3838 will result in the depletion of resources available for R & D. Consequently, R & D spending will, out of necessity, decline. This is true notwithstanding the bill's retention of the R & D tax credit.

We would also like to take this opportunity to reiterate our position that R & D expenditures must not be included as a preference item for purposes of computing alternative minimum tax liability (see page 11 of NMTBA testimony).

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SASSER FROM

JAMES H. MACK

Q.2. Second, it has been estimated that over half of total world trade volume is comprised of internal intermediary transactions of multinational corporations. For example, as long ago as 1978, $700 billion of the $1.3 trillion in world exports was accounted for by such international transactions -- most of which was in advanced technology.

I would like to know how this trend towards multinationalization influences the machine tool industrial groups. What are the implications of the trend for American workers, and for the U.S. tax base? What would be the impact of H.R. 3838 on this trend?

A. 2. Multinationalization

While I cannot point to a "trend" towards multinationalization in the machine tool industry, I can tell you that cooperative joint ventures between foreign and domestic machine tool manufacturers have increased in recent years, as has the movement of machine tool production capacity offshore (see page 4 of NMTBA testimony). We believe that these developments could have been at least partially arrested had the Administration acted promptly on the industry's 232 Petition for temporary import relief. By increasing our nation's reliance on foreign sources for critical items like machine tools, we are unnecessarily increasing the threat to our defense base. Passage of H.R. 3838 will hasten that reliance by substantially increasing the cost of capital for American industry, thereby causing an even higher share of U.S. productive capacity to move offshore.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM

PAUL R. HUARD

Q. 1. In testimony before the Senate Finance Committee last week, former assistant Treasury secretary Paul Craig Roberts stated that the basic problem with H.R. 3838 is that "it raises the marginal tax rates on new investment and uses the proceeds to lower the average tax rate on labor income and on investments already in place."

a. Do you agree with this statement?

b. Does H.R. 3838 effectively raise the cost of capital while weakening the competitive position of U.S. industry abroad? How does the tax bill do this?

Answer 1. (a) NAM agrees with the view that H.R. 3838 would raise the marginal tax rate on new investment. As detailed in our statement, the aggregate increase in the rental price of capital would be in the area of 17.8%. This estimate is based on an analysis by Fiscal Associates; nevertheless other estimates, including those by major econometric forecasting groups, have arrived at similar figures. In essence, the deletion of ACRS and the ITC raise the user cost of capital by magnitudes of up to 25%, and other provisions of the proposed tax reform would do little to alleviate this.

(b) The effects on trade must be acknowledged to be indirect. The one area in which the United States is competitive vis-a-vis foreign suppliers is in the area of capital costs; it is clearly uncompetitive in areas such as labor costs and the exchange rate. Thus the primary implications of the tax bill for competitiveness would be to further undermine the position of American firms in an area in which their current situation is not as unfavorable as their situation in the aggregate.

Q. 2. The so-called tax reform bill contains provisions that would limit employee accumulation of retirement funds through their employers. Therefore this deferred compensation would be paid as taxable wages.

a. Would this provison have an adverse effect on the process of capital formation because it reduces the capital base for pension funds?

b. If we impede the process of capital formation and thereby increase the cost of capital, don't we make it harder for American industry to become competitive with foreign manufacturers?

Answer 2. The Senator is correct. There are two public policy underpinnings of tax defferred pensions. First, Congress wanted to expand the pool of private savings available for capital and plant equipment; and second, Congress wanted to promote private income security. To a certain degree both results have obtained.

With respect to the pool of private savings, undeniably the savings rate has gone up because of IRA's, KEOGH's, 401(k) plans and other income deferral programs. While some of this new saving is traceable to borrowed money, much is not and what is borrowed become irrelevant when repaid. This concern does not present itself under various deferred compensation plans. The resulting expanded pool of savings tends to relieve the crowding out effect thereby putting downward pressure on interest rates.

The second objective--private income security--is also being met. Americans are saving for retirement in greater numbers than ever before. In years to come, as Americans mature and retire, the pressure on the Federal government to provide tax-supported retirement income will be reduced considerably.

The Tax Reform Act of 1985, rather than expanding on these programs by making them both more generous and more attractive to low and middle income groups, actually contracts the coverage. For example, H.R. 3838 requires a dollar for dollar offset against IRA's for contributions to a 401(k) plan. Thus a $2,000 contribution to a 401(k) plan eliminates the IRA all together. Moreover, there are numerous new and unnecessary anti-discrimination rules as well as reduction in contribution caps. All of these are opposed by the NAM.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM
PAUL R. HUARD

Q. I read with interest your contention on page 6 of your testimony that the U.S. has a tax system that encourages consumption to a far greater degree than tax codes of our trade competitors. You provide some interesting data on that page about our European competitors, but nothing on Japan. Do you have such data on Japan? Can you make it available to the Committee?

A. The generalization about consumption taxes is applicable to most of the European countries, but not to Japan. The Japanese tax system does in fact emphasize taxation of income rather than consumption, although it incorporates provisions designed to encourage saving and investment. First, the rate of taxation of capital gains for individuals is much lower than in the United States. Secondly, individuals are able to deduct savings from taxable income up to a given limit (similar to the provision for IRAs adopted in 1981). There are also non-tax factors which have been associated with high rates of saving in Japan, among them a strong cultural preinclination toward saving, but of equal importance, the lack of a comparable system of social security; this has produced powerful incentives for individuals to save heavily for retirement.

Thus it is fair to say that the causes of lowerrates of saving in the U.S. are only partially attributable to provisions of the U.S. tax code. However, Japan's extraordinary success in international trade may well be attributable less to its high rates of saving and capital formation than to the fact that the yen has been consistently undervalued except for brief periods in 1974 and 1978-80. Nevertheless, this should not be taken to imply that the competitive position of the United States would not benefit from a shift toward taxation of consumption along the same lines as in Western Europe.

Q. Mr. Clark of Citibank expressed concerns on page 2 of his testimony that the foreign tax credit provisions of H.R. 3838, will impede the growth of U.S. exports. Some economists contend that the main reason our exports to Latin America have dropped off is that those countries are using most of their export earnings to pay interest on their debts rather than to purchase new goods. These economists contend that our exporters are suffering so that our banks will not have to take a hit on their balance sheets by writing off some of what appears to be bad debt. Do you agree that there is necessarily a conflict in our debt strategy between what would benefit our exporters as opposed to bank stockholders?

A. There is no inherent confict of interest between the interests of banks that have loaned out funds to Latin American countries and American exporters. The reasons why this is the case have to do with the fact that the causes of the debt crisis and the decline in U.S. exports are essentially the same: they have to do primarily with the appreciation of the dollar. The effects of the massive 1981-85 appreciation of the dollar on exports are well known. What is less generally understood is that the realignment in exchange rates contributed to (if not caused outright) the Third World debt crisis, by increasing by magnitudes of several hundred percent, the real value of Third World debt. Because the foreign debt of the Latin American countries is denominated in dollars, an appreciation of the dollar increases the real outstanding value of external obligations.

The implication is that the same policy priority, (i.e., a devaluation of the dollar, is necessary both to protect American banks against the risk of bad debt losses, and in order to raise exports. In the event that the dollar were to be brought down to something approaching its equilibrium value, there would be several salutary effects on the American economy. First, our exports would tend to increase due to the restoration of purchasing power parity. Secondly, overall global economic activity would increase, due to the fact that in the absence of the constraint implied by an appreciating dollar,other countries would be in a position to reflate their economies. In this situation, Latin American countries would be better able to service their debt both because of the decline in the real value of this debt implied by the devaluation of the dollar and because of the improvement in worldwide demand for their exports. Thus in the final analysis, both American banks and American exporters would benefit from a lower dollar.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM

PAUL R. HUARD

Q.1. James C. Miller,III, the director of the Office of Management and Budget, recently stated in an article in THE WASHINGTON POST on January 28, 1986 that: "If we raised taxes on 'business,' we'd see them passed on to consumers in the form of higher prices or lead to less investment in plant and equipment, and therefore fewer jobs." What is your response to Miller's statement? Since you have argued that the impact of the House bill is to effectively raise taxes, even while it is lowering the maximum corporate tax rate to 36%, will it lead to higher prices, less investment and fewer jobs? How does this compare to President Reagan's tax proposal?

A.1. Dr. Miller's statement in the Washington Post is correct in part--taxes ultimately are paid by consumers. It is true that some portion of all taxes show up in the price of a consumer good. From time to time, however, and for sound business reasons, a corporation may decide to absorb increased costs or to pass them on to shareholders in the form of decreased returns on equity. This is particularly true when--as now--American made goods are having difficulty competing with foreign made goods both here and abroad.

The second point--that higher taxes lead to reduced levels of business investment in capital and plant equipment--is true particularly if the tax is on capital. The repeal of the investment tax credit coupled with changes in depreciation take us from near the top among major industrialized countries to dead last in terms of our ability to recover investments in capital and plant equipment. Therefore, it stands to reason that some manufacturing capacity will leave for more favorable shores. The resulting loss of manufacturing jobs will be offset in part by new jobs in the service sector--but only in part. We believe, and others concur, that unemployment will increase if H.R. 3838 is passed.

These effects are true even though the corporate rate is dropped to 36 percent. This rate reduction is financed by increased taxes on capital intensive industry. This sector of the manufacturing community will be the hardest hit by the Tax Reform Act of 1985.

With respect to the President's proposal, the effect is much the same. Clearly H.R. 3838 is worse than the President's plan--but neither are good. Both bills suffer from the same flaw--rate reductions are financed by new taxes on capital intensive industry.

Q.2. You have stated that the House tax bill will seriously worsen the competitive standing of U.S. corporations vis-a-vis corporations in other countries from the standpoint of tax deductions and credits applicable to new capital investment. How does the current level of investment tax credit compare to other countries, (such as Japan, Western European states)? What will be the impact of these decreased tax incentives? Is the impact the same under the Reagan plan as under the House plan? If both proposals decrease U.S. competitiveness in this area vis-a-vis other states, what areas would you like to see addressed by a tax reform proposal that will make us more competitive compared to our major trading partners?

A.2. In order to compare tax incentives for capital investment, new product development and export promotion, a rather detailed methodology is required. A limited analysis is presented in Appendix III of our statement of February 4. This analysis surveys provisions with respect to the recovery of capital costs, including investment tax credits and depreciation, discounted for expected inflation. According to this analysis, the United States currently ranks fourth with respect to computer equipment and mining equipment and fifth for manufacturing equipment in a sample of fifteen industrial and semi-industrial countries. Under HR 3838, the United States would rank eighth, for computer equipment and fifteenth (i.e.: last) for mining and manufacturing equipment.

In terms of NAM's priorities vis-a-vis any reform of the tax code, the major need of the business sector is to retain the ITC and the ACRS depreciation system. Other possible priorities include the enactment of some form of consumption tax instead of increasing revenues by repealing investment incentives.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SASSER FROM

PAUL R. HUARD

Q. It is an obvious fact of economic life in the United States that if we are going to sustain our standard of living, we are going to have to reverse the trend in the trade balance, both by meeting the competition in domestic markets and by expanding our export markets. That means maintaining a climate for innovation. It also means promoting fair international trading practices, but I limit my inquiry here to the impact of the tax bill.

U.S. market share of high-technology exports dropped from 30 percent to 24 percent during the 1970s. That was before the skyrocketing interest rates of the early 1980s, and before the value of the dollar rose precipitously against other currencies. Obviously, there was a distortion of worldwide industrial capacities in the years following World War II. And there were going to be adjustments. But we had a trade deficit in 1985 of almost $150 billion. That is more of an adjustment than I am willing to make.

The Banking Committee's focus is on the impact of the tax bill on U.S. export capacity. I would like to have some examples of the impact of taxes on two major areas:

First, what specific kinds of investments have been made with R&D tax credits in manufacturing generally that will make U.S. products more competitive on world markets? Are these investments primarily in products or in processes? I understand that the benefits of research and development are hard to see at the front end, but where is the major potential?

In your answer, please address one particular concern associated with the R&D tax credit. There have been references in the past to the fact that a well-known fast-food company claimed an R&D tax credit for a new sauce for a particular chicken product. This sauce was in fact a product; it was new and innovative; and it was developed in a laboratory for carrying on trade during a year in which the company increased its R&D above its previous three-year average.

How do you differentiate that from the potential for major developments in science and engineering?

Second, it has been estimated that over half of total world trade volume is comprised of internal intermediary transactions of multinational corporations. For example, as long ago as 1978, $700 billion of the $1.3 trillion in world exports was accounted for by such international transactions -- most of which was in advanced technology.

I would like to know how this trend towards multinationalization influences American manufacturers in general. What are the implications of the trend for American workers, and for the U.S. tax base? What would be the impact of H.R. 3838 on this trend?

Sasser's question
RE: The Implications of H.R. 3838, the Tax Reform Act

A. The problem with our trade balance is not related to R&D abuses. Instead, the problem is related to the Federal deficit. Unrestrained Federal spending has over-valued the dollar to the point that U.S. goods are not competitive in foreign markets.

Parenthetically, I might note that the story of an R&D credit for sauce is--so far as I can tell--an old wives tale. However, even if true that story would not justify an abandonment of America's commitment to technology.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM

ROBERT HOSTETLER

Q. **1. In testimony before the Senate Finance Committee last week, former assistant Treasury secretary Paul Craig Roberts stated that the basic problem with H.R. 3838 is that "it raises the marginal tax rates on new investment and uses the proceeds to lower the average tax rate on labor income and on investments already in place."**

a. Do you agree with this statement?

b. Does H.R. 3838 effectively raise the cost of capital while weakening the competitive position of U.S. industry abroad? How does the tax bill do this?

A. 1. EIA certainly does agree with former Assistant Treasury Secretary Paul Craig Roberts that H.R. 3838 "raises the marginal tax rates on new investment and uses the proceeds to lower the average tax rate on labor income and on investments already in place."

It is precisely this kind of provision in H.R. 3838 which is ill-timed in that it raises the cost of capital for an industry struggling to compete internationally. Whereas rate reduction for individuals and corporations has merit, it should not be done at the expense of vitally important tax provisions which promote capital investment and technological innovation.

Examples in H.R. 3838 which would have this effect are the reduction in the value of the 25% R&D tax credit; changes in Section 861 allocation requirements; elimination of ITC and changes in depreciation rates and schedules. These specific issues are treated in EIA's written statement.

EIA prefers to pay for rate reductions, etc through some form of a broad based consumption tax.

Q. 2. The so-called tax reform bill contains provisions that would limit employee accumulation of retirement funds through their employers. Therefore this deferred compensation would be paid as taxable wages.

a. Would this provison have an adverse effect on the process of capital formation because it reduces the capital base for pension funds?

b. If we impede the process of capital formation and thereby increase the cost of capital, don't we make it harder for American industry to become competitive with foreign manufacturers?

A. 2. The savings rate of individuals is a very important aspect of our nation's ability to form capital. Consequently, incentives for saving rather than spending should be an integral part of any major tax reform proposal. Employer provided retirement programs and tax deferred savings plans such as 401(k) plans should be encouraged. At the same time, taxes on spending should be carefully crafted and designed so as to reward rather than penalize savings.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM
ROBERT HOSTETLER

Q.1. On page 2 of your testimony you refer to our country's massive trade deficits of the last few years and note rightly - I believe - that "the United States has become a debtor nation; we are mortgaging our future standard of living with interest and debt service payments."

In hearings before this Committee many witnesses have told us the overvalued dollar of recent years has been the primary reason for our massive trade deficits and the overvalued dollar is mainly a result of our huge budget deficits. Do you agree? Please explain why or why not.

A. 1. There is no question that the overvalued United States dollar has played a significant part in creating our trade deficit; however, it is a mistake to think that a cheaper dollar will end our trade deficit problems. Economists have estimated that a dollar decline would reduce the trade deficit only by 25% to 35%. The fact is that 65% of U.S. trade is with countries whose currencies float with or below the dollar. In any event, as the U.S. dollar depreciates we can expect our trading partners to call for U.S. currency control on outflows just as calls are made today on the Japanese in response to a depreciating yen. In addition, we could expect that a sudden and a substantial drop in the value of the dollar would result in an increase in inflation in the United States. We agree that today's dollar is overvalued and that its value should be reduced. This step, however, should be taken in conjunction with measures designed to remove the impediments against U.S. exports and foreign trade which now hinder American business. In this context it just does not make sense to place tax restrictions on U.S. companies doing business overseas while our trading partners offer export and other tax incentives to their national companies.

Q.2. Mr. Clark of Citibank expressed concerns on page 2 of his testimony that the foreign tax credit provisions of H.R. 3838, will impede the growth of U.S. exports. Some economists contend that the main reason our exports to Latin America have dropped off is that those countries are using most of their export earnings to pay interest on their debts rather than to purchase new goods. These economists contend that our exporters are suffering so that our banks will not have to take a hit on their balance sheets by writing off some of what appears to be bad debt. Do you agree that there is necessarily a conflict in our debt strategy between what would benefit our exporters as opposed to bank stockholders?

A. 2) No, I do not think there has to be a conflict in our trade and debt strategies. Granted, healthy economies throughout the world would help everyone's trade balance. That is not the case, and the U.S. remains committed to bolstering the world economy by assisting developing nations where, and in ways, appropriate.

Our own tax and trade policies should be established to encourage exports, and not be compromised by the host of complicated economic and monetary problems such as fluctuating currencies.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM

ROBERT HOSTETLER

Q.1. **You have recommended that some form of broad based consumption tax be considered as a way to reduce the federal deficit. Without going into all of the arguments regarding the problems surrounding the imposition and collection of such a value-added tax, what impact would such a tax have on exports within your industry?**

A. 1. One favorable aspect of a consumption tax, such as the value added tax or business transfer tax, is its ability to reduce the trade deficit. A value added tax on imports would correct the existing anomaly whereby U.S. exports are subject to a border tax by our foreign competitors while their exports are eligible for a rebate upon export. Imposition of a border tax by the United States on imports would at least put us on a level playing field with our competitors.

Q.2. **James C. Miller,III, the director of the Office of Management and Budget, recently stated in an article in THE WASHINGTON POST on January 28, 1986 that: "If we raised taxes on 'business,' we'd see them passed on to consumers in the form of higher prices or lead to less investment in plant and equipment, and therefore fewer jobs." What is your response to Miller's statement? Since you have argued that the impact of the House bill is to effectively raise taxes, even while it is lowering the maximum corporate tax rate to 36%, will it lead to higher prices, less investment and fewer jobs? How does this compare to President Reagan's tax proposal?**

A. 2. My written statement amplifies this very scenario which Mr. Miller suggests. A shift of the magnitude of $140 billion of taxes onto industry is bound to be met by a transfer back onto consumers. Amounts not transferrable to consumers would have to come from capital which should be available for investment in plant and equipment.

To the extent that President Reagan's earlier proposal also eliminated the investment tax credit and stretched out depreciation schedules, it would be as harmful as H.R. 3838 to the process of capital formation, innovation, growth and jobs. The President's proposal would have, however, retained the full 25% R&D tax credit which is preferable to the provision in H.R. 3838.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SASSER FROM
ROBERT HOSTETLER

Mr. Hostetler:

Q. 1. It is an obvious fact of economic life in the United States that if we are going to sustain our standard of living, we are going to have to reverse the trend in the trade balance, both by meeting the competition in domestic markets and by expanding our export markets. That means maintaining a climate for innovation. The electronics industry, as you point out in your testimony, is particularly well aware of that point. Reducing the trade deficit also means promoting fair international trading practices, but I limit my inquiry here to the impact of the tax bill.

U.S. market share of high-technology exports dropped from 30 percent to 24 percent during the 1970s. That was before the skyrocketing interest rates of the early 1980s, and before the value of the dollar rose precipitously against other currencies. Obviously, there was a distortion of worldwide industrial capacities in the years following World War II. And there were going to be adjustments. But we had a trade deficit in 1985 of almost $150 billion. That is more of an adjustment than I am willing to make.

The Banking Committee's focus is on the impact of the tax bill on U.S. export capacity. I would like to have some examples of the impact of taxes on two major areas:

First, what kinds of investments have been made with R&D tax credits in the electronics industry that will make U.S. products more competitive on world markets? Are these investments primarily in products or in processes? I understand that the benefits of research and development are hard to see at the front end, but where is the major potential?

In your answer, please address one particular concern associated with the R&D tax credit. There have been references in the past to the fact that a well-known fast-food company claimed an R&D tax credit for a new sauce for a particular chicken product. This sauce was in fact a product; it was new and innovative; and it was developed in a laboratory for carrying on trade during a year in which the company increased its R&D above its previous three-year average.

A. 1. Senator Sasser, one example of the kind of investment in R&D which I think epitomizes the electronic industry's attempt to remain at the cutting edge of technology, is that of the Microelectronics and Computer Technology Corporation (MCC) in Austin, Texas. Their work on super-computers can, to a certain extent, be considered possible because of incentives such as the credit, and to the recent clarification of the antitrust laws regarding joint ventures. Basic R&D is an expensive, but vital, element of our innovative process which is exemplified in all segments of our industry, from semiconductors to super-computers.

I would have to make a rough guess that an equal amount of qualified R&D is in products and processes.

As to certain misuses of the R&D tax credit in the past, I think it is very important to note that sufficient tightening and clarification of the definition of qualified R&D has been accomplished in House and Senate legislation. Pending legislation, including the credit provisions in H.R. 3838, does not allow nonresearch activities to qualify for the credit, such as post-research activities, adaptation, surveys, etc. The credit is strictly limited to research activities designed to produce technologically new or improved business items, for which all the activity fits a defined process of experimentation relating to functional aspects of the product.

Q. 2. **How do you differentiate that from the potential for major developments in science and engineering in electronics?**

Second, it has been estimated that over half of total world trade volume is comprised of internal intermediary transactions of multinational corporations. For example, as long ago as 1978, $700 billion of the $1.3 trillion in world exports was accounted for by such international transactions -- most of which was in advanced technology.

I would like to know how this trend towards multinationalization influences the electronics industry. What are the implications of the trend for American workers, and for the U.S. tax base? What would be the impact of H.R. 3838 on this trend?

A. 2. The fact that over 50% of world trade is accounted for by multinational corporations, only points out that multi-nationals have a lot of opportunities to influence international trade statistics. In fact, I would argue that international trade within multi-national corporations is likely to respond even faster to changes in the tax system in a given country than the balance of international trade. It is easy for CTS to make a decision to build a product for the U.S. market in an overseas plant because of changes in the tax code than it is for our customers to switch from a domestic to a foreign supplier. So, therefore, the fact that over half of world trade volume is comprised of internal, intermediary transactions of multi-national corporations only enhances the need to provide a tax system that encourages domestic production.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM

GEORGE J. CLARK

1. In testimony before the Senate Finance Committee last week, former assistant Treasury secretary Paul Craig Roberts stated that the basic problem with H.R. 3838 is that "it raises the marginal tax rates on new investment and uses the proceeds to lower the average tax rate on labor income and on investments already in place."

a. Do you agree with this statement?

b. Does H.R. 3838 effectively raise the cost of capital while weakening the competitive position of U.S. industry abroad? How does the tax bill do this?

2. The so-called tax reform bill contains provisions that would limit employee accumulation of retirement funds through their employers. Therefore this deferred compensation would be paid as taxable wages.

a. Would this provison have an adverse effect on the process of capital formation because it reduces the capital base for pension funds?

b. If we impede the process of capital formation and thereby increase the cost of capital, don't we make it harder for American industry to become competitive with foreign manufacturers?

Senator D'Amato's Questions Regarding the Impact of H.R. 3838 on the Competitive Position of U.S. Industry Abroad.

ANSWER: The National Foreign Trade Council appeared to testify on the impact of H.R. 3838, the House-passed tax reform bill, in connection with the ability of U.S. companies to compete in foreign markets and in particular, the ability of U.S. banks to continue to make cross-border loans to foreign borrowers in countries such as LDCs.

The b. paragraph of your first question asks whether H.R. 3838 would effectively raise the cost of capital while weakening the competitive position of U.S. industry abroad. The National Foreign Trade Council emphatically believes that this would be the result if the foreign provisions of H.R. 3838 were adopted as final law. The reason is that these provisions, particularly those relating to cutbacks in the ability of U.S. companies to claim the foreign tax credits on their foreign source income from overseas operations and services, would very substantially weaken their competitive position vis-a-vis foreign companies, including the position of U.S. banks vis-a-vis foreign banks.

In the case of small, regional and money-center banks, the denial of foreign tax credits on interest earned on cross-border loans made to foreign borrowers, particularly LDC borrowers, would place U.S. banks at a severe competitive disadvantage with foreign banks, and would have a very negative impact on the ability of U.S. banks to finance exports to countries which impose cross-border withholding taxes (a large number of which are LDCs). Foreign banks do not face the onerous restrictions in their respective foreign tax credit systems such as those proposed by H.R. 3838. In fact, in many instances, foreign tax credit systems are more liberal than the current U.S. foreign tax credit system.

The H.R. 3838 changes in the foreign tax credit and in the source of income rules, the allocation of interest expense, as well as the repeal of deferral for banking, insurance and shipping companies, and other types of income would have a serious anti-competitive effect on the ability of many U.S. multinational companies to operate in foreign countries.

The a. part of your question 1. and question 2. do not relate to the subject matter of the National Foreign Trade Council's presentation before the Committee.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM

GEORGE J. CLARK

Q. On page 3 of your testimony you make it sound as if the Baker Initiative on developing country debt was something designed to benefit the U.S. government, rather than the exposed banks. You say, for example "reluctant U.S. banks would like first to be repaid, but instead are going to be asked to put up new funds" Secretary Baker himself in testifying before the Senate Foreign Relations Committee on his plan said "If the program ...works, all participants, including the banks will be better off. If it does not succeed, the banks as well as the borrowing countries will be worse off."

So it appears the Plan is designed at least in significant part to help our banks. What choice does Citibank have but to go along with the Baker Plan? What are your other options? I can see the regional and smaller banks have other options - but I wonder about the exposed money center banks. Your comment, please.

Senator Proxmire's Question Regarding the Baker Initiative and Whether Citibank Supports This Plan.

ANSWER: The Baker plan was designed to increase economic growth in the LDC countries and to foster social and political stability. Certainly, U.S. banks would benefit from the internal economic growth and stabilizing of the LDC countries to which they have made loans, both to the governments and the private sector. Additionally, the increased economic health of these countries would further enable them to import U.S. products, which would create a major benefit for the U.S. trade balance and U.S. jobs.

Citibank as of this time has indicated full support for the general philosophy and purpose of the Baker plan and agrees with the statement made by Secretary Baker before the Senate Foreign Relations Committee to the effect that if the Baker initiative works, all participants, meaning the LDC's and U.S. and foreign lenders, will be better off. However, if the foreign tax credit is substantially cut back on LDC loans, as is proposed under the House-passed tax reform bill, Citibank, like regional and smaller banks, would seriously have to reconsider its position with respect to future lending to borrowers in countries where U.S. tax credits could not be claimed against withholding taxes imposed by the borrower's country.

Q. You voice concerns on page 2 of your testimony that the foreign tax credit provisions of H.R. 3838, will impede the growth of U.S. exports. Some economists contend that the main reason our exports to Latin America have dropped off is that those countries are using most of their export earnings to pay interest on their debts rather than to purchase new goods. These economists contend that our exporters are suffering so that our banks will not have to take a hit on their balance sheets by writing off some of what appears to be bad debt. Do you agree that there is necessarily a conflict in our debt strategy between what would benefit our exporters as opposed to our bank stockholders?

Senator Proxmire's Question Regarding "a Conflict in Our Debt Strategy".

ANSWER: If the LDC debt problem is not resolved, borrowers in LDC countries who import U.S. products would find it very difficult to obtain credit. This would seriously impede their ability to finance the importation of U.S. goods and services. The only apparent "conflict in our debt strategy" is created by the House bill provision which would seriously reduce foreign tax credits available to U.S. banks on cross-border loans to borrowers in LDC countries. This conflicts with the Baker Initiative to encourage U.S. banks to make loans to these countries in order to stimulate their internal economic growth. Many of these loans would be made to finance the importation of U.S. products which are necessary to the economic growth of these countries. The House bill is clearly at cross purposes.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM

GEORGE J. CLARK

Q. You have argued that H.R. 3838 jeopardizes the $400 billion LDC debt restructuring effort and the Baker Initiative to stimulate the growth and development of LDC countries. What is the impact of the Reagan tax proposal on these two efforts? If you feel that Reagan's plan also has a negative impact on these two efforts, what type of tax proposal do you feel would have a beneficial impact on the debt restructuring effort and the Baker Initiative?

Senator Riegle's Questions Regarding Debt Problems in LDCs.

ANSWER: The President's proposal would have a negative impact for banks in connection with the $400 billion of LDC debt restructuring and the Baker Initiative. It is to be noted, however, that the President's proposal was not specifically aimed at banks but would have impacted almost all U.S. multi-national companies which have income from foreign sources. The President's tax proposal (Reagan I) would have repealed the overall method for calculating the foreign tax credit and imposed a "per country" limitation, which would have generally applied to all U.S. multinational companies that have foreign source income. The per country limitation would also cause severe anti-competitive foreign tax credit problems for multinational businesses, including banks. The per country method would have created virtually insoluble compliance problems for taxpayers and the IRS. The Reagan plan would cause the loss of foreign tax credits for taxes paid to high-tax countries, of which the LDCs are a significant number.

The important difference between the President's proposal and the House-passed tax reform bill is that under the latter, banks are singled out for discriminatory and otherwise punitive treatment with respect to their ability to claim foreign tax credits in connection with cross-border loans to foreign borrowers, particularly in LDC countries.

In view of the fact that both the President's proposal and the House-passed bill would have a very serious impact on the LDC debt issue and the Baker initiative, as well as on the ability of U.S. banks to compete in international markets and to provide financing for U.S. exports, it is strongly recommended that the only alternative is to retain current law which puts U.S. banks on an essentially equal footing with foreign banks in terms of competing in the international market place. Otherwise, if either the President's proposal or the House bill provisions are adopted as final law, U.S. banks will be forced to cut back or in many cases discontinue foreign cross-border lending, particularly to LDC countries.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM

LOWELL R. BECK

For Mr. Beck:

Q. Section 1022 of H.R. 3838 requires that property and casualty insurance companies reduce annual increases in loss reserves by 10% of the interest income on any municipal bonds purchased after November 15, 1985. This reduction goes to 15% in 1988. Thus, all bonds owned prior to 11/15/85 are exempt from this provision. Anytime a pre 11/15/85 bond is sold and the proceeds re-invested in a municipal bond, the insurance company incurs a tax on the new purchase. This makes trading pre 11/15/85 bonds prohibitively expensive and in effect locks up the portfolio.

Wouldn't a better way to accomplish the intent of the law and free up the pre 11/15/85 bonds for proper and prudent portfolio management, be to use a schedule of tax exempt income generated by such bonds? Couldn't this be accomplished if each company would provide such a schedule, showing the yearly run-off of tax exempt income, and any tax exempt income over and above such schedule would be subject to the above provision?

Would this alternative method of accounting for grandfathered tax exempt income, reduce any income deemed to have come from this provision and lock-up insurance company portfolios?

RESPONSE TO QUESTION OF SENATOR D'AMATO

Answer: **The National Association of Independent Insurers strongly opposes section 1022 of H.R. 3838 which would require property and casualty insurance companies to reduce their deduction for losses incurred by 10% of their interest income on exempt obligations, and the deductible portion of dividends received on stock, acquired after November 14, 1985. The** reduction is increased to 15% in 1988. The provision amounts to a direct tax on exempt income which has not previously been imposed on any other taxpayer by Congress and which is unwarranted here.

Nonetheless, in the event a determination is ultimately made to impose a tax on exempt income earned by property and casualty insurance companies, a grandfather provision such as your question appears to contemplate has merit. As we understand your proposal, a property and casualty company would, in effect, take a snapshot of its exempt portfolio to reflect (i) the level of tax exempt interest it would earn, and (ii) the redemption patterns, with respect to exempt obligations it holds as of the grandfather date. The company would then be able to exclude from the section 1022 tax base in future years exempt interest in the amounts and over the same redemption periods as it would have excluded if it had continued to hold the obligations that it held on the grandfather date, even though such obligations are in fact subsequently sold and reinvested in other exempt obligations.

Although NAII continues to object to section 1022 of H.R. 3838, it does believe that a scheduling approach such as you have outlined has merit and might alleviate some of the problems that could otherwise arise as a result of forcing property and casualty insurers to continue to hold specific exempt obligations.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SASSER FROM LOWELL R. BECK

Q. 1. MR. BECK, YOUR STATEMENT EXPRESSES YOUR SUPPORT FOR THE PROVISION IN THE HOUSE BILL CALLING FOR A PHASE-IN OF 20 PERCENT OF A COMPANY'S UNEARNED PREMIUM RESERVES AS INCOME FOR TAX PURPOSES OF/A PROPERTY/CASUALTY INSURANCE COMPANY. IS SUPPORT FOR THIS PROVISION UNIVERSAL AMONG PROPERTY/CASUALTY INSURORS? WHAT DO SMALL INSURANCE COMPANIES HAVE TO SAY ABOUT THIS PROVISION? WON'T LARGE INSURANCE COMPANIES WHICH ARE PART OF A CORPORATE CONGLOMERATE BE ABLE TO AVOID ANY NEW TAX FROM THIS PHASE-IN SINCE THEY FILE CONSOLIDATED RETURNS?

RESPONSES TO QUESTIONS FROM SENATOR SASSER

Answer. 1. The property and casualty insurance industry is represented by the American Insurance Association, the Alliance of American Insurers, the National Association of Independent Insurers, the National Association of Mutual Insurance Companies, and the Reinsurance Association of America. Together, these associations represent more than 2,000 P&C companies--virtually all P&C companies in the United States. All types of P&C insurers, consolidated and nonconsolidated, large and small, are represented. None of these member companies has expressed any opposition to consolidation. All five industry associations, and even P&C companies not affiliated with an association, endorsed the so-called "revenue offset" proposal to include 20% of unearned premiums in income at commencement of the policy term. We are aware of no opposition from any element of the P&C industry, to the "revenue offset" proposal.

Consolidated companies are not able to avoid the impact of this provision. Assume that a P&C company which is a member of a consolidated group has an underwriting loss. That loss is deductible in consolidation against the taxable income of other members of the consolidated group. The effect of the "revenue offset" proposal would be to reduce the underwriting loss deductible against consolidated taxable income and therefore to increase the tax liability of the consolidated group.

Q. 2. YOUR STATEMENT ALSO SETS OUT SOME AREAS WHERE YOU BELIEVE THE HOUSE WENT TOO FAR IN TAXING PROPERTY/CASUALTY INSURORS. AS YOU KNOW, THERE IS A SCHOOL OF THOUGHT WHICH CONTENDS THAT WITH THE CURRENT CRISIS IN AFFORDABILITY AND AVAILABILITY OF PROPERTY/CASUALTY INSURANCE, THE HOUSE BILL DOESN'T GO NEARLY FAR ENOUGH. THIS POINT OF VIEW CONTENDS THAT ONE OF THE LEADING CULPRITS FOR THE CURRENT WOES IN THE INSURANCE INDUSTRY IS THE FACT THAT LARGE CORPORATE CONGLOMERATES WHICH MAY OWN AN INSURANCE SUBSIDARY ARE ONLY INTERESTED IN THE INSURANCE COMPANY FOR PREMIUM/DOLLARS OR UNDERWRITING LOSSES WHICH CAN BE PASSED THROUGH TO COVER OTHER INCOME OF THE CONGLOMERATE BY FILING A

CONSOLIDATED TAX STATEMENT. ADVOCATES OF THIS POSITION GO ON TO ASSERT THAT WE OUGHT TO REPEAL THE PROVISIONS IN THE TAX CODE WHICH ALLOW FILING OF SUCH CONSOLIDATED TAX RETURNS AND LOOK AT INDIVIDUAL INSURORS ON THEIR OWN MERITS. MANY IN CONGRESS WHO ARE CONCERNED WITH ESCALATING INSURANCE PREMIUMS BELIEVE THERE IS MERIT IN THIS ARGUMENT. WHAT ARE YOUR THOUGHTS ON THIS PROPOSITION?

Answer. 2. There is a problem of insuring certain risks in the current legal climate. In areas such as malpractice liability, product liability, directors and officers liability and others, potential damage awards are so staggering that P&C companies must require substantial premium increases in order to avoid a financial catastrophe in the industry. The insurance problems simply reflect the underlying problems of tort liability law in these areas.

Moreover, in the recent era of soaring inflation, P&C companies were able to earn high investment returns. As a result, competitive forces drove down premium rates. With interest rates now reduced investment income is down, and accordingly, premiums must be increased to permit companies to cover their escalating costs.

H.R. 3838 exacerbates the problem. The increased tax liabilities under the House bill would result in additional upward pressure in premiums that are already being raised in many lines to provide adequate reserves to cover the dramatic increase in liabilities.

If insurance companies were to be denied the right to consolidate, the problem you described would be compounded still further. In consolidation, a P&C company's net operating loss can be used as a deduction against taxable income of other members of the consolidated group. Denying deductibility of the loss, by repealing consolidation, would be likely to have an effect similar to most any other tax increase--namely, to result in higher premiums.

Tax increases, whether in the form proposed in H.R. 3838 or in such form as a denial of consolidation rights, must be regarded as increases in the cost of carrying on an insurance business. Like any business, insurers will seek to recover these increased costs from customers to the extent possible. At a time when policyholders are already facing premium increases because of changes in the legal climate regarding such areas as medical malpractice, product liability and others, imposing additional costs through the tax system seems especially unwarranted.

Q. **3. MR. BECK, WHAT ARE YOUR VIEWS OF THE ALTERNATIVE MINIMUM TAX CONTAINED IN THE HOUSE BILL? WHILE IT MAY HAVE SOME SHORTCOMINGS, ISN'T THIS PROVISION AT LEAST AN ATTEMPT TO FOCUS ON** TRUE ECONOMIC INCOME FOR PROPERTY/CASUALTY COMPANIES? DOESN'T THE ALTERNATIVE MINIMUM TAX BEGIN TO GET US AWAY FROM THE PROBLEM OF LOSS PASS-THROUGH AVAILABLE IN CONSOLIDATED RETURNS?

Answer. 3. Under H.R. 3838, property and casualty insurance companies are subject not only to the alternative minimum tax that applies generally to corporations, but are also subject to a special provision that operates as a type of "minimum tax" on a P&C company's net gain from operations. Through this latter provision, property and casualty insurance companies would be subject to tax penalties that would apply to no other taxpayers.

The special provision for P&C companies would have the effect of imposing a minimum tax on all tax-exempt interest (subject to a limited grandfather rule). For all other taxpayers, tax-exempt interest (except for interest on "nonessential function bonds") would not be subject to a minimum tax.

Under the special "minimum tax" for P&C companies, P&C losses could not be used in a consolidation. The alternative minimum tax applicable to other taxpayers would have no prohibition against the use of losses in a consolidation.

The special P&C company "minimum tax" would deny deductibility against the minimum tax base of net operating losses being carried forward from pre-effective date years. All other taxpayers would be permitted to deduct such losses against their minimum tax base.

In short, the so-called "minimum tax" provision directed at P&C companies is a hastily drafted, punitive provision that departs from the basic minimum tax rules that would apply to all other taxpayers.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM

THOMAS P. MALETTA

HOUSEHOLD
INTERNATIONAL

Thomas P. Maletta
Vice President-Taxes

February 11, 1986

The Honorable Jake Garn
United States Senate
Subcommittee on Housing and Urban Affairs
Washington, DC 20510

Dear Senator Garn:

With reference to your letter of February 5, 1986, I am pleased to provide the following response to Senator D'Amato's questions:

1. What will the effect of H.R. 3838 be on the cost to the FSLIC for the sale of savings & loans under assisted mergers?

   In cases where FSLIC assistance is needed as an incentive for a solvent S&L to acquire a troubled S&L, the healthy S&L will in all likelihood require the amount of FSLIC assistance be increased to account for the tax benefits which H.R. 3838 would repeal. We estimate that the proposal to treat FSLIC payments as taxable income will, by itself, increase by 56% the amount of FSLIC assistance required in such takeovers.

   H.R. 3838 will also eliminate the existing rules which allow the merger of an insolvent S&L into a solvent S&L to qualify as a tax free reorganization. Repeal of this tax incentive will mean that less acquisitions of troubled S&Ls will occur, and the FSLIC will incur the cost of maintaining additional troubled S&Ls.

2. What is the effect on bank holding companies that own consumer finance subsidiaries of the foreign tax provisions?

   Since Household Finance Corporation is a S&L holding company rather than a bank holding company, I am best able to answer this question in the context of the effect on S&L holding companies. H.R. 3838 will require that a portion of the U.S. interest expense of the S&L holding company and its consumer finance subsidiaries will be allocated against the foreign source finance and non-finance income of the S&L holding company. This will greatly reduce, and in some cases eliminate, the foreign tax credit with respect to the earnings from the foreign operations.

   This permanent loss of foreign tax credits will drive up the effective tax rate on foreign income to levels much higher than the U.S. tax rate, thereby making such foreign operations totally uneconomic. S&L holding companies faced with this situation would undoubtedly dispose of their foreign operations. During the sell-off period, the high effective tax rates would place the affected S&L holding companies at a disadvantage with foreign financial institutions operating in the U.S. and with other domestic financial institutions which do not have foreign operations.

3. Since H.R. 3838 would drastically reduce the maximum contributions to 401(k) plans, eliminate IRAs for anyone contributing over $2,000 to a 401(k) plan, and otherwise limit the ability to invest, doesn't this bill effectively discourage those able to save from saving? Therefore, doesn't H.R. 3838 promote consumption and not saving?

   Section 401(k) plans and IRAs help provide the much needed pool of savings this country requires for economic expansion. By restricting and limiting §401(k) and IRA contributions, H.R. 3838 certainly does encourage individuals to consume today rather than save for tomorrow. We feel this is a very short-sighted approach, both in terms of the retirement security of millions of Americans as well as for the economic well-being of the nation. It is sadly ironic that although Congress often bemoans the relentless competition to American industry from Japanese products, which is made possible in large part due to the high rate of savings in Japan, that the House of Representatives, in H.R. 3838, is actively seeking to reduce the amount of savings by Americans.

Again, I wish to thank you for allowing me to testify on February 4, 1986 before the Committee on Banking, Housing and Urban Affairs, and for giving me the opportunity to address Senator D'Amato's questions. It is unfortunately true that in the areas discussed above as well as in numerous other areas, H.R. 3838 has adopted positions which can only be described as anti-business, anti-investment and anti-savings. We would be most appreciative of any help you, Senator D'Amato and the other members of the Committee can provide to rectify these matters.

Senator, if there is any assistance I can give you, Senator D'Amato, or the other members of the Committee in these endeavors, please let me know.

Sincerely,

Thomas P. Maletta

Thomas P. Maletta

MAD0181

cc: Senator Alfonse M. D'Amato

THE IMPLICATIONS OF H.R. 3838, THE TAX REFORM ACT

WEDNESDAY, FEBRUARY 5, 1986

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 9:30 a.m., in room SD–538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, D'Amato, Gorton, Mattingly, Hecht, Cranston, Dixon, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The Chairman. The Banking Committee will come to order.

Today, the committee continues with the second of 3 days of hearings on the House-passed bill H.R. 3838. Today's hearing focuses on the bill's impact on the safety and soundness of banks and the savings institutions as well as the financing of foreign trade.

The committee appreciates the willingness of each of our witnesses today to testify and in addition to your testimony today we would ask that you respond next week to any written questions that would come from the committee.

We recognize that this is a very short turnaround period, but I feel that in order to make the committee's report useful and get it to the Finance Committee that we need to expedite the process as rapidly as we can. And we also have a number of additional statements we have requested to be included in the record from many organizations that we do not have the time to hear orally. So we're happy to have each of you with us today.

Do any of my colleagues have any opening comments they wish to make before we begin?

STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'Amato. Mr. Chairman, I have a rather extensive opening statement in which I note that you are to be commended for holding these hearings.

I don't think that anyone could say that I have been the most ardent supporter of the big banks and their activities, but let me say that——

The Chairman. Except for the New York banks.

Senator D'Amato. Except for New York banks when they have been unduly excluded from interstate banking.

But let me say that H.R. 3838 has some devastating impacts on the banking system of America at a time when this committee is attempting to encourage banks to write off bad loans and provide greater loss reserves. In essence H.R. 3838 would penalize them for setting up adequate reserves by taxing them while we are trying to urge them to do just the opposite.

I don't know what our House colleagues were thinking of at that moment. Maybe they were thinking of some of the Washington Post headlines.

The CHAIRMAN. Well, they obviously were not thinking.

Senator D'AMATO. That's correct. So it really does a great disservice to the American public to further exacerbate a difficult situation that our financial institutions are in and believe me, H.R. 3838 will do just that.

Today we commence the second of three hearings that the Banking Committee has planned to examine the consequences of H.R. 3838, the Tax Reform bill passed by the House last December. Yesterday's hearing clearly demonstrated that the description of H.R. 3838 as tax reform is a gross mischaracterization. While the bill may be labeled as tax reform, the contents of this package does not accomplish the intended goals of tax reform: Fairness, simplicity and economic growth. Instead, H.R. 3838 represents a tangled web of political compromise that is so complicated that legions of attorneys and accountants have yet to determine the consequences of its provisions; promotes inequities in the Tax Code rather than fairness; and will impede, if not totally retard, economic growth.

Yesterday's witnesses demonstrated that H.R. 3838's treatment of investment tax credits and depreciation alone could adversely affect the economy. They argued that H.R. 3838 would: (1) slow economic growth and the creation of New jobs by discouraging investment in new plants and equipment; (2) impair the international competitiveness of American companies; and (3) transfer wealth away from capital formation, discourage savings, and thereby create consumer demand—demand that will be satisfied by foreign competitors since American corporations will be weakened by the bill.

I anticipate that the substance of this morning's testimony will continue to reveal flaws in H.R. 3838. For example, the loan loss reserve provisions of the tax bill imposes a method of accounting on large commercial banks and requires the payment of tax on reserves deducted in previous years. I don't understand the reason to repeal the loan loss reserve deduction which has been employed by banks for the last 65 years. The logic behind the repeal of this provision escapes me, at a time when we are faced with questions concerning the adequacy of Federal Deposit and Insurance funds and the safety and soundness of banking institutions. Although I have been a vociferous critic of bank lending and repayment practices which have resulted in undermining the stability of some banks, I think that H.R. 3838 exacerbates the present repayment problems resulting from these bad loans. Therefore, we had better reconsider the repeal of the loan loss reserve provisions.

The consequences of H.R. 3838's treatment of foreign tax credits must also be examined. We must determine the effects of this provision on the competitiveness of U.S. industries in world markets at a time when this country is confronted with a huge trade deficit.

Finally, H.R. 3838 contains provisions including the net operating loss rules and bad debt reserves that merit examination. These provisions and others demonstrate a failure to recognize the realities of the economic crisis confronting the savings and loan industry. Although the S&L industry experienced a profitable year in 1985, record numbers of S&L's still remain on the critical list. The S&L industry is just beginning to recover from a traumatic period. It is ludicrous for us to even contemplate changes in the taxation of these institutions that could precipitate a rash of failures for the sake of raising marginal amounts of revenues.

I hope that during our examination of H.R. 3838, we can reveal some of the major flaws in this legislation. Our efforts should not be undertaken with a desire to criticize our colleagues in the House, but to ensure that we accomplish the goals of tax reform—simplicity, fairness, and economic growth.

The CHAIRMAN. Senator Dixon.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am delighted to welcome back here a warm friend, Mr. Chip Backlund of Peoria, who is the distinguished president of the Independent Bankers Association of America, and we are delighted to have his expertise this morning.

I am pleased to be here this morning as the committee continues its examination of the implications of tax reform for areas of the committee's jurisdiction. The tax reform proposals now before Congress are probably the most comprehensive and the most important we have faced in modern times.

As I stated yesterday the need for fundamental reform is great. The Federal Government is currently unable to collect approximately 20 percent of the taxes it is owed—and that number is growing. A majority of American taxpayers believe our tax laws are inequitable, and 20 percent admit to cheating on their taxes.

Simplifying our tax laws and making them more equitable must therefore be among our highest priorities. We would not be facing terrible budget deficits of $200 billion or more if voluntary compliance with our Nation's tax laws was better. In fact, we would have had budget surpluses, or at least balanced budgets until the last few years, all without placing any new burden on the vast majority of honest American taxpayers.

Having said that, however, I must also say that I am deeply concerned that regarding the implications both the President's proposal and H.R. 3838 may have on our ability to generate savings and capital on interest rates, on our balance of trade on the economic health of major segments of our economy and on our ability to generate strong, consistent real economic growth.

We have before us this morning a very distinguished and expert group of witnesses from the banking and thrift industries. I look forward to hearing from them on issues such as loan loss reserves, the deductibility of interest on debt used to purchase or carry tax-exempt obligations, net operating losses, taxation of foreign operations, the special tax rules for troubled thrifts, and other issues of concern. I appreciate their willingness to provide the committee with the benefit of their analysis of tax issues and their recommendations for change. I'm sure their views will help all members of the Banking Committee as we consider tax reform issues.

The CHAIRMAN. Senator Mattingly.

OPENING REMARKS OF SENATOR MATTINGLY

Senator MATTINGLY. Mr. Chairman, I just commend you for holding the hearings. I think there are two very important issues with regard to the tax credit and the loan loss reserves. I'm very interested to learn really what the elimination of the loan loss reserve would have on the ability to compete in—actually all of them—what impact they would have on our ability to compete in the global economic with reference to trade and I think it's really going to impact the soundness of our system and I hope that you all address that issue.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Gorton.

OPENING REMARKS OF SENATOR GORTON

Senator GORTON. Mr. Chairman, as I understand it, this is the second of 3 days which will be devoted to the subject of the House-passed tax reform bill, each concentrating on two or more elements of the business community which are under the general jurisdiction or purview of this committee.

It may be, Mr. Chairman, that at some time in these 3 days you will find a witness who has something nice to say about H.R. 3838. I don't believe you have yet and I haven't found much to say which will commend it.

These witnesses, of course, are going to be primarily concerned with the impact of the bill on the American economy, but that impact goes far beyond particular businesses or enterprises which they represent and goes to what our economy is going to look like over the course of the next decade or more, whether we can compete fairly with aggressive foreign enterprises, whether or not we can provide for the kind of growth which the President was talking about in his address last night, it is something of a paradox, it seems to me, that we have an administration-backed proposal which in my view will hurt the ability of the country to reach the very goals which the administration itself outlines.

The CHAIRMAN. Thank you, Senators.

Other than the fact that I think the tax bill is antibusiness, anti-capital formation, anti-investment, and neither simplification nor reform—and no one will ever convince me that nearly 1,400 pages of the bill is tax simplification—I haven't made up my mind how I feel about it—except that it will never see the light of day, because if it's in this form by the time it comes back from the Finance Committee, my voice will be back and I will be able to talk at great length.

It's interesting—Senator Gorton, you mentioned that we couldn't find a witness to speak in favor of the bill, and that is essentially true. We did invite some groups who have kind of quietly said they favored H.R. 3838, but they chose not to accept our invitation to testify. So we did not stack the deck with witnesses who are all opposed to the bill. Those who are in favor of the bill are, I suppose, a little bit embarrassed and simply didn't want to be shown here in the light of day testifying in favor of that turkey that the House produced. But I still have an open mind on H.R. 3838.

Senator **Mattingly**. Mr. Chairman, I might ask if there's a House member that may want to come testify. I think they would be hard to find also.

The **Chairman**. Right. Now, Mr. Senterfitt, please go ahead.

STATEMENT OF DONALD T. SENTERFITT, VICE CHAIRMAN, SUN TRUST BANKS, INC., ATLANTA, GA; PRESIDENT, AMERICAN BANKERS ASSOCIATION, ACCOMPANIED BY RICHARD C. AMACHER, CHAIRMAN, TAXATION COMMITTEE, AMERICAN BANKERS ASSOCIATION

Mr. **Senterfitt**. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee; my name is Donald T. Senterfitt. I'm vice chairman of Sun Trust Banks, Inc., in Atlanta, and I'm the president of the American Bankers Association. With me today is Richard C. Amacher, chairman of ABA's taxation committee and senior vice president and manager-taxation of Mcorp in Dallas, TX.

I appreciate the opportunity to testify today on the pending tax legislation and ask that our written statement with attachments be included in its entirety in the record.

The **Chairman**. It will be.

Mr. **Senterfitt**. Our written testimony spells out in detail the negative consequences of specific provisions of H.R. 3838. I will not pretend to be able to compact a serious discussion of those points into the few minutes that we have here.

Instead, Mr. Chairman, I come here today as a representative not only of the industry that I serve but of the communities that our banks serve. The real impact of H.R. 3838 problem provisions which ABA has identified will hurt people, small businesses, and large companies that have traditionally turned to banks as financial intermediaries.

Although a bank's role as financial intermediary would not be obliterated as a result of H.R. 3838, that bill, if passed as written today, would seriously impede the role you and Federal regulators want banks to play.

That is particularly the case with regard to management of our institutions' own portfolios, the working out of troubled loans with farm, energy, timber, high-tech, and other borrowers, the availability of credit—including exports—and the continuity which trust customers seek from their local banks back home.

TAX ON LOAN LOSS RESERVES

For instance, H.R. 3838 contains a provision that totally wipes out the tax deductability of even the present small part of a bank's true loan loss reserve. This, Mr. Chairman, is purely and simply a tax on capital because as you well know, loan loss reserves are a part of a bank's capital as computed by our regulators. The practical effect of returning the tax loan loss reserve to income is to drain our capital accounts. All this comes at the very moment when Congress and the regulators are insisting that bank capital be strengthened. With no rhyme or reason, H.R. 3838's disincentive to build up capital directly targets banks of $500 million and over.

By discriminating among banks according to asset size, H.R. 3838 creates different tax treatment for competing banks serving the same markets. This is despite the fundamental tenet of our Nation's banking laws that the need to maintain adequate loan loss reserves to ensure safe and sound banking operations is equally real for both large and small banks.

Is there any rationale for the $500 million cutoff? The answer is, "No." Is public policy served by this new tax? "No."

More importantly, is it wise public policy or fiscal policy to penalize, ex post facto, problem borrowers seeking to restructure their debt just because they went to a bank which had over $500 million in assets? "No." Most importantly, is the presumed revenue gain which never reaches $1 billion in any year and which is less than $500 million in 1986, worth the cost to your local economies? "No again."

Over the years the IRS has tried to find a formula for computing a reasonable addition to the reserve for bad debts. Experience has shown that these fixed formulas distorted appropriate deductions over a period of time; at times too high, at times too low. It would seem that the correct answer is book/tax conformity. Senators Roth and Boren have introduced a bill, S. 1263, that would allow a deduction for tax purposes for additions to a bad debt reserve if the amount is also claimed as a charge against earnings for financial statement purposes. It represents the most accurate matching of loan loss expenses with income that can be achieved.

DISALLOWANCE OF INTEREST DEDUCTION ON TAX-EXEMPT OBLIGATIONS

H.R. 3838's disallowing of 100 percent of the interest deduction associated with carrying tax-exempt obligations acquired after January 1, 1986, or even after 1987 creates immediate problems for the existing portfolio of tax-exempt obligations.

A bank is able to make a profit on these obligations through the tax savings that come from the obligations' tax-exempt status. When a bank is encountering losses on its other loans, the decline in taxable income may erase any profit from its tax-exempt portfolio. That is precisely when the bank needs to be able to sell its tax-exempt obligations and replace them with taxable loans paying a higher rate.

This liquidity is very important to the safety and soundness of the banking system, yet H.R. 3838 seriously jeopardizes the liquidity of tax-exempt obligations by preventing their sale to other banks.

The impact of these problems could be reduced if banks were allowed to continue to buy and sell their existing portfolios of tax-exempt obligations within the banking industry.

But again, the more important question is this: Is the minimal projected revenue gain from the proposed tax-exempt bond carrying-charge provisions—yes, only $29 million in 1986 and never even reaching more than $100 million in any year—worth the cost to your own cities and towns? I say the answer is a clear, "No."

Issuers back in your home States are already being hurt in their ability to raise funds merely by the possibility that H.R. 3838 will pass. Yet critics of our position assert that banks can merely shift their markets. Maybe so, because we are under the statutory mandate and the regulatory requirement to handle other people's money in a safe and sound manner. But cities and towns lose.

Similar questions can be raised about the foreign loan provisions in H.R. 3838. For instance, only banks are denied the full creditability of gross withholding taxes paid in lieu of income taxes.

I won't take the time at this point to go over this area in detail. I would, however, like to indicate my agreement with the testimony on this issue that will be given by Mr. Shipley on behalf of the New York Clearing House. Similarly, I will not comment now on the other issues—cash accounting, net operating loss carryovers, IRA's, and the treatment of trusts—that are discussed in our written statement. These issues are important, however, especially ones like the repeal of cash accounting that will hit hard at smaller banks without sophisticated accounting skills.

Mr. Chairman, you have asked how H.R. 3838 would affect the competitiveness of the banking industry. The ABA has long supported the idea of a level playing field for financial institutions. To the extent that certain provisions of H.R. 3838 help to achieve equal tax treatment, we applaud them. We find, however, that on the whole, the bill does not help to achieve this goal.

In fact, H.R. 3838 will increase the current unequal treatment. The availability of a tax loan loss reserve to a bank will now depend on the bank's size, while all thrifts, regardless of size, will be able to maintain a reserve equal to 5 percent of taxable income. Credit unions will continue to remain untaxed, so no tax reserve is necessary.

The continuing, if not increased, inequalities between financial institutions that would be the result of H.R. 3838 also heightens the need for banking to be able to offer new products and services. If tax policy requires that the tax-deferred savings plans that we can offer, such as IRA's, are to be further restricted, then let us have insurance powers so that we too can offer tax-deferred annuities. Let us commingle funds so that the 401(k) plans we market can be fully competitive.

Mr. Chairman, you called these hearings to find out how bank operations would be affected. The provisions ABA has identified will hit us hard. And it will hit the people we serve very hard also.

I urge you to read the ABA's written testimony and talk to your colleagues on the Finance Committee. It is imperative that they understand the consequences of H.R. 3838 on banks and on the communities that the banks serve.

Again, Mr. Chairman, we appreciate the opportunity to testify on this important issue. We would be happy to supply any additional information you may need.

The **Chairman**. Thank you very much, Mr. Senterfitt.

[The complete prepared statement follows:]

STATEMENT OF DONALD T. SENTERFITT ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

I am Donald T. Senterfitt, Vice Chairman, SunTrust Banks, Inc., Atlanta Georgia, and President of the American Bankers Association. I am accompanied today by Richard C. Amacher, Chairman of the ABA's Taxation Committee and Senior Vice President and Manager-Taxation, Mcorp, Dallas Texas. I am appearing here on behalf of the American Bankers Association. The American Bankers Association is the national trade and professional association for America's Full Service Banks. The combined assets of its member banks represent approximately 95 percent of the industry's total assets.

I want to thank this Committee for the opportunity to testify and to compliment you, Mr. Chairman, for holding these oversight hearings. The effort to reform the income tax system is an extremely complex undertaking. We are pleased that you are taking an independent look at how the House-passed tax reform bill, H.R. 3838 impacts the banking industry. The American Bankers Association cannot support H.R. 3838. We think you will find that the bill contains a number of provisions that have a substantial negative effect on banks. We are particularly concerned over the proposed elimination of the tax loan loss reserve for banks and bank holding companies with assets greater than $500 million; the proposed disallowance of 100 percent of the deduction for carrying charges related to tax-exempt obligations; and the numerous proposed changes in the taxation of foreign source income.

As a result of these changes, banks will no longer be able to deduct the economic losses that they incur. They may well become the only American industry with significant levels of prepaid taxes on their balance sheets. Banks will be blocked from participating in the tax-exempt markets. They will be faced with charging higher yields on money lent abroad and, as a result, losing business to foreign competitors. They will be paying taxes at higher marginal rates than their principal competitors; savings and loans and credit unions. None of these dangers to banking are necessary to achieve true tax reform.

Two years ago, in anticipation of the current activity in the area of tax reform, the ABA selected a task force of economists and tax executives from a cross-section of our membership. This task force was charged with the detailed examination of the various tax reform proposals and with the assessment of the impact of such proposals on banks and the economy as a whole. The group examined the theoretical underpinnings of the reform proposals, as well as the technical applications of individual items. We studied the Bradley-Gephardt, Kemp-Kasten, Roth-Moore, VAT, and Brookings proposals. We spent several months studying first the Regan Treasury proposal and then the President's proposal. Since

September our attention has been focused on the bill as it emerged from the House Ways and Means Committee.

Before beginning my discussion of the specific proposals in H.R. 3838 affecting banking, I would like to discuss the role banks play under the current system. An understanding of that role is necessary to fully appreciate the effects of tax reform on banks.

We believe there are three important elements to the way banks are currently taxed. First, banks are generally subject to tax under the same rules as other taxable corporations. Second, the tax benefit a bank receives from purchasing a tax-exempt bond or doing a finance lease, for the most part, is passed directly through to the city or state selling the bond or to the corporate lessee. In general, a bank's bottom-line profit on such transactions varies little from its profit on a straight taxable loan. Third, banks pay over $2 billion annually into the Treasury as a result of the reserves they are required to maintain with the Federal Reserve System. This quasi-tax is in addition to paying all of the costs of regulating banking incurred by the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Federal Reserve System. It is the combined effect of these three elements that determines a bank's true effective tax rate. A survey conducted on 1983 income by the Bank Administration Institute asked banks to recalculate their taxes to reflect the earnings of Treasury on the reserves provided to the Federal Reserve System and a tax equivalent analysis of municipal bond income. The result was an effective tax rate of 43 percent.

By purchasing tax-exempt bonds and engaging in leasing transactions, banks are fulfilling the role Congress has encouraged them to perform, that of financial intermediary, a transfer agent through which tax benefits flow to others. This means that a bank's profits would not be significantly decreased or increased if it ceased being a transfer agent. Any changes to this role might increase the effective tax rate of banks, but the real economic burden would be on the state and local governments, school boards, and businesses that would no longer be able to borrow at reduced rates.

The Joint Committee on Taxation staff has recognized the effect this role has on banking's effective tax rate. In their 1983 pamphlet discussing the way banks are taxed they stated, "To the extent that these investments by banks earned a lower pre-tax rate of return than comparable but fully taxable investments, it may be argued that the banks did bear an indirect economic burden attributable to the income tax apart from the actual tax payments they made."

All banks must post reserves with the Federal Reserve System on an interest-free basis in direct ratio to their transaction accounts and nonpersonal time deposits. The reserves held by the Federal Reserve System are then invested primarily in government securities. While this is not thought of as a tax--because it directly generates revenue that is brought into the Treasury as miscellaneous receipts--it clearly represents a financial contribution by the banking industry to the revenues available to pay the direct costs of government. As indicated above, the annual earnings on their reserves over the last few years has averaged over $2 billion. In 1980 and 1981, it reached a high of $3 billion.

Banking receives no benefit from this quasi-tax. The costs associated with the Federal Reserve's regulatory and service activities are taken out before any funds are transferred to the Treasury. The funds needed by the Federal Deposit Insurance Corporation and the Comptroller of the Currency to regulate banks are paid directly to those agencies by the industry. They do not come out of general Treasury revenues.

The view that the earnings on the reserves represent a quasi-tax is shared by the Chairman of the Federal Reserve Board, Paul Volcker. In a 1983 statement to the Senate Banking Committee he said, "Reserve requirements, while imposed for monetary policy purposes, also, from the viewpoint of the depository institution, represent a form of tax."

While the role of banks as financial intermediaries and the quasi-tax paid through the Federal Reserve System are very important to an accurate understanding of bank taxes, it must also be remembered that, in general, the same tax rules that apply to other taxable corporations also apply to banks. There seems to persist, however, a belief that banks must benefit from a number of "special" provisions in the Tax Code. This belief appears to be the result of the various studies claiming to show that the effective tax rate of banks is very low. An examination of the tax law for those features that are important in studies of effective tax rates reveals that, by and large, "special provisions" or "tax preferences" designed for banks are not involved. Instead, the single most important factor in reducing the Federal income taxes paid by banks is the exemption from Federal income tax of interest paid by state and local governments on their obligations. Another large component of the reduction for major institutions is the credit allowed for foreign taxes imposed by other countries on income earned by the taxpayer in those countries. A third large component is the combined effect of the investment tax credit and depreciation deductions from equipment leasing operations. None of the tax reducing effects of these provisions of the Federal tax law is attributable to the enjoyment of a special provision by banks.

I now would like to turn to the specific provisions of H.R. 3838 that have the most direct impact on the banking industry. The most important of these is the proposed repeal of the tax loan loss reserve for large banks. The ABA strongly believes that maintaining adequate loan loss reserves is an essential aspect of sound banking. Over time a bank's loan portfolio will decline in value as it becomes clear that certain loans or portions thereof will not be paid back. The use of a reserve for loan losses allows banks to deduct the decline in value as it occurs rather than waiting until the loan has become completely worthless. The concept is very similar to allowing a manufacturing concern to deduct its investment in machinery over time through depreciation rather than at the time the machine becomes worthless.

This decline in value of a loan portfolio is real; it is not an artificial accounting concept or "tax shelter" as some in the press have labeled it. For example, the present depression in the agricultural sector has made it difficult for many farmers to pay back loans. Some will and others will not. Banks do not know which farmers will succeed and which will not. Banks do know, however, that the collateral value of farm land, crops and equipment, has declined significantly. The loan loss reserve concept allows banks to recognize the decline in value of farm loans without having to identify and charge-off which particular loans will not be repaid. These same problems are present today in the oil fields of Texas, Oklahoma, and Colorado, in the timber industry of Oregon, and even in the silicon valleys of California.

Repealing the use of a loan loss reserve for tax purposes will require banks to charge-off loans in order to get tax deductions. This makes no sense for banks or their customers. One of the principal benefits of maintaining reserves for loan losses is that banks can work with borrowers who are in trouble and still recognize the decline in value of those loans. Banks want to be able to work with borrowers with the objective of achieving full repayment of the loans as opposed to charging-off the loans and trying to collect on the collateral through foreclosures.

Banks of course, must maintain reserves for regulatory and financial accounting purposes. The repeal of the use of loan loss reserves for tax purposes, however, will create certain regulatory accounting problems that may impair bank capital. Due to recent accounting pronouncements by the FDIC and the Comptroller of the Currency, the tax effect of the excess of the loan loss provision for regulatory purposes over the allowable tax deduction may not always be recorded as a benefit on regulatory financial statements. This could result in a major reductions of banks capital. If banks were able to fully deduct currently the real losses in the loan portfolio for tax purposes as well as for regulatory accounting purposes, no such capital reduction would occur.

H.R. 3838, by discriminating among banks according to asset size, creates different tax treatment for competing banks serving the same markets. This provision runs completely against the fundamental tenets that gave rise to the entire tax reform effort. The need to maintain adequate loan loss reserves to ensure safe and sound banking operations is equally real for both large and small banks. The ability of a bank to work with troubled borrowers should not be dictated by tax rules which differ according to an arbitrary size distinction.

Over the years the IRS has tried to find a formula for computing a reasonable addition to the reserve for bad debts. Experience has shown that these fixed formulas distorted appropriate deductions over a period of time; at times too high, at times too low. It would seem that the correct answer is book/tax conformity. Senator Bill Roth (R-DEL) and Senator David Boren (D-OKLA) have introduced a bill, S. 1263, that would allow a deduction for tax purposes for additions to a bad debt reserve if the amount is also claimed as a charge against earnings for financial statement purposes. No deduction would be allowed for additions to a book reserve which is in excess of 1.5 percent of total loans. There are also limitations which would ensure that any adjustment required to bring the book and tax reserves into conformity will be done gradually over a period of years.

This is not an open ended invitation to banks to decrease their tax liability. One of the major responsibilities of bank management is to maximize earnings. At a 36 percent marginal tax rate, bank management would not be interested in artificially reducing earnings by 1 dollar to get a 36 cent tax benefit.

In addition, there are a number of different regulatory authorities looking at the reserves established by a bank. The banking regulators are concerned not only with the level of the reserve but whether the bank has sound procedures in place for regularly reviewing their loan portfolio. The banking regulators would be very concerned with any bank that greatly increased its loan loss reserve whenever it was making substantial profits.

The Securities and Exchange Commission (SEC) would also be looking closely at any bank that suddenly increased its loan loss reserve. They would be asking why if such an increase was necessary, the bank had not reported it earlier. They too would be looking to see if the bank had sound policies in place for examining its loan portfolio. Like the banking regulators, the SEC, can, and does, impose substantial penalties in those instances where there is a violation of proper reporting procedures.

Generally Accepted Accounting Principles (GAAP) require that the adequacy of the loan loss reserve be determined on the basis of all relevant factors. These include but are not limited to, loss experience, changes in size and character of the loan portfolio, identification of problem situations which may affect a borrower's ability to repay a loan and evaluation of current economic conditions.

As indicated above, the book reserve is a measurement of the decline in value of a bank's loan portfolio. It is calculated using GAAP as recognized by the accounting profession. The use of the book reserve for tax purposes would recognize the differences between the loan portfolios of different banks. It represents the most accurate matching of loan loss expenses with income that can be achieved.

Our second major concern with H.R. 3838 is the provision which would disallow 100 percent of the interest deduction associated with carrying tax-exempt obligations acquired after January 1, 1986. We have opposed this provision since it will effectively stop banks from purchasing tax-exempt obligations or making tax-exempt loans in the future. The proponents of this provision apparently assume that individuals and other investors will fill the void left by banks. While we wonder whether this assumption is true, that is, perhaps, more the concern of the states, cities, and local units of government than it is of the banks.

Of more direct concern to the banks are the problems created for the existing portfolio of tax-exempt obligations. A bank is able to make a profit on these obligations through the tax savings that come from the obligation's tax-exempt status. When a bank is encountering significant loan losses, the resulting erosion in its taxable income may erase any profit from its tax-exempt portfolio. A bank encountering these problems must be able to sell its tax-exempt obligations and replace them with taxable loans and investments paying higher rates. "Liquidity", the ability of a bank to convert its non-cash assets into cash, depends upon existence of a ready market for a bank's tax-exempt obligations, and is very important to the safety and soundness of the banking system. H.R. 3838 could seriously jeopardize the liquidity of tax-exempt obligations by Preventing the sale of existing, bank-owned, tax-exempt obligations to other banks.

This provision also creates problems when a banking organization acquires another bank. The banking system currently is undergoing a substantial number of mergers and acquisitions. The form of the acquisition, purchase of the bank stock or its assets, should not trigger substantially different tax consequences. Under the House bill, the direct acquisition of a bank's tax-exempt portfolio will trigger the 100 percent loss of the deduction for carrying charges. This generally would not occur if the bank stock and not its assets are acquired. The tax laws should not create such a substantial price difference based on the form of the transaction. These problems could be alleviated if banks were allowed to continue to buy and sell, among each other, their existing portfolios of tax-exempt obligations without imposition of the 100 percent disallowance. We believe this change in the provision is needed to solve the problems outlined above.

We continue to oppose, however, the 100 percent disallowance on new purchases. Banks have long played an important role in the financial affairs of their communities and should be encouraged to continue to play that role. A city facing a financial crisis may find it far more difficult to solve it if the local banks cannot help.

The third area of H.R. 3838 that is of major concern to banking is the proposed changes in the taxation of a bank's foreign source income. Foreign lending has become increasingly competitive in recent years. Any additional tax might force U.S. banks out of many overseas markets. Foreign lending by U.S. banks supports U.S. trade. Our manufacturing and service industries rely heavily on U.S. banks to finance the goods and services that they export as well as their foreign operations. Because of the role foreign loans by U.S. banks play in financing the sales of U.S. commodities, products and services abroad, a reduction in the competitiveness of U.S. banks would have an adverse impact on U.S. trade, our balance of payments, and even on domestic employment. If American banks were replaced by foreign banks, these banks would work to replace U.S. goods and services with those from their own countries.

H.R. 3838 appears to single out banking for especially harsh treatment. Only banks are denied the full creditability of gross withholding taxes paid in lieu of income taxes. Banking is one of the few industries singled out for the elimination of deferral. These changes will negatively affect many existing lending arrangements as well as future financial activities.

The provision denying full creditability for gross withholding taxes is particularly harmful to banking. This only affects so called cross border lending, where the U.S. bank makes the loan directly from the U.S. to a borrower in a foreign country. Because the U.S. bank often does not have any operations in the foreign country, that country will impose a tax on the interest payments made to the U.S. bank. Since no deductions are allowed and the tax is paid to the foreign government by the payor, the borrower, the tax is known as a gross withholding tax. Most countries, including the U.S., impose these taxes to ensure that income earned in the country but paid directly to a foreigner is taxed.

These are the taxes imposed on the billions of dollars in loans U.S. banks have made directly from the U.S. Many of these loans are to borrowers in Latin America and less developed countries. These loans were made under the assumption that the U.S. tax rules would continue to allow full credit for all gross withholding taxes paid to foreign governments. In this manner, the U.S. bank is assured it will not be taxed twice on the same income, once by the U.S. and once by the foreign government. The severe limitations contained in the House bill on the ability to credit the foreign taxes against U.S. tax will retroactively change the profitability of many of these loans. It will also force U.S. banks to charge higher rates on these types of loans in the future, and risk being priced out of the market.

There are, of course, several other provisions in H.R. 3838 that will have substantial effects on banks and the products they offer. I would like to briefly discuss some of them now.

Banks that experience a net operating loss currently may deduct that loss against income from their prior ten years of operation and, if necessary, from their next five years. Other corporations can only go back three years but can go forward fifteen years. H.R. 3838 would place banks under the same rules as other corporations. For banks that have experienced losses and have no income in earlier years, this change is beneficial. Many banks, however, particularly in the farm belt still have income in earlier years but currently are experiencing heavy losses. The provision in present law allowing banks to look back ten years was designed to help cushion banks in this position. While we believe the change contained in H.R. 3838 will be helpful in the long run, we believe a more gradual change would be appropriate.

H.R. 3838 requires all service businesses with annual gross receipts of more than $5 million to use the accrual method of accounting. The adjustment to affect the change would be computed by taking the difference between the previously unreported accrued income and accrued expenses as of December 31, 1985. This amount would be added to or deducted from taxable income over a period not to exceed five years. The cash method of accounting has been accepted as "clearly reflecting income" over the years from 1913 to the present for businesses without inventories as long as the method is used on a consistent basis from year to year. Since the primary source of a financial institution's income is derived from the monthly payment of interest on loans, the cash basis method clearly reflects income on an annual basis. Therefore, we do not believe it is necessary for financial institutions to be required to use the accrual method of accounting.

Another provision of H.R. 3838 links together an employee's contributions to Individual Retirement Accounts (IRAs) and Cash and Deferred Arrangements (401(k) plans). The provision prevents employees from contributing to an IRA if they contribute more than $2,000 to a 401(k) plan. Banks market both of these retirement plans, IRAs to individuals and 401(k) plans to employers. Many banks also have established 401(k) plans for their own employees. Given the current low rate of savings in the U.S., we cannot understand this attempt to discourage the use of IRAs by employees who participate in 401(k) plans.

In contrast to the announced goals of fairness growth and simplicity, ABA believes the provisions of H.R. 3838 pertaining to the income taxation of trusts and estates will have the opposite result. From the perspective of banks who will have to administer the proposal, we oppose the change because the costs of compliance to government and the private sector will be substantially increased.

Two systems of tax will be required for many years to come because many existing trusts will continue under current law. Fairness dictates this result but the costs in training people, compliance, developing rules and regulations, developing and maintaining forms and systems, and a host of other aspects in administering and complying with radically divergent tax systems call into question even the minimal revenue estimates of these provisions.

Under H.R. 3838 trustees will have to establish and administer tax reserve accounts with which to pay income taxes that under current law are paid by the beneficiary receiving the income and will have to invest this reserve to produce income. Time problems will occur in connection with the filing of calendar year trust income tax returns because the grantor or designated beneficiary will not make an allocation until his or her return is prepared, which usually will be shortly before, or, in many cases, after the trust return is due to be filed because the individual has obtained an extension of time to file.

In addition, the House passed provisions create enormous difficulties for fiduciaries who must allocate tax rate brackets among trusts established by a decedent and the decedent's estate. Because any agreement must be executed by all fiduciaries, any one of these entities has the right to prevent agreement and obtain an equal benefit from allocation. What is a fiduciary to do in such a case? No solution to the trustee dilemma is offered in the House passed bill. The Appendix more fully describes the substance of the House bill and its effect on trusts.

The tax on generation-skipping transfers was enacted in 1976. There is broad agreement among all segments of the estate planning, trust, and tax communities that the law is hopelessly unworkable. Even Treasury has acknowledged that fact. ABA worked for retroactive repeal of existing law until late 1984 when, hoping to resolve what appeared to be an impasse, our Association supported a Treasury substitute with a single amendment. Banking took that position because we believed that the Treasury proposal which incorporated a series of delicate compromises was preferable to existing law. The House of Representatives in H.R. 3838 made a number of changes to the Treasury proposal which unfortunately disrupt the fragile balance. We consider H.R. 3838's generation-skipping proposal undesirable, among other reasons, because of the burden it places on trustees.

1. It vastly increases administration difficulties by imposing multiple generation-skipping taxes within a single trust.

2. It eliminates the modest annual *de minimis* beneficiary exemption which will lead to onerous unproductive return and reporting requirements on small payments.

To fully appreciate the effect of H.R. 3838 on banking, it is also useful to look at the way other financial institutions would be taxed. Achieving a level playing field for all financial institutions was one of the Treasury Department's original goals for tax reform. The Treasury Department stated that the tax preferences of financial institutions "...create distortions within the financial sector that are inconsistent with the Administration's efforts to deregulate financial markets. Equity and neutrality demand that all financial institutions be taxed uniformly on all of their net income."

The ABA has long supported the idea of a level playing field for financial institutions. To the extent that certain provisions of H.R. 3838 help to achieve equal tax treatment, we applaud them. We find, however, that, on the whole, the bill does not help to achieve this goal.

The President proposed equal treatment of bad debt losses for all depository institutions by seeking to repeal the reserve method of accounting. While this would have achieved equality among depository institutions, it would not, in our view have been sound tax policy. We believe equal treatment demands that all depository institutions be able to maintain reserves to protect against known but unidentifiable losses that are inherent in their portfolios.

Unfortunately, H.R. 3838 will increase the current unequal treatment. The availability of a tax loan loss reserve to a bank will now depend on the bank's size, while all thrifts, regardless of size, will be able to maintain a reserve equal to 5 percent of their taxable income. Credit Unions will continue to remain untaxed, so no tax reserve is necessary.

We find particularly upsetting the different treatment accorded savings and loans. The net affect of the 5 percent reserve is to reduce their marginal tax rate from 36 percent to 34 percent. The 5 percent of net income bears no relationship to actual losses incurred by the thrifts. We understand the rationale behind this special reserve, an additional subsidy for housing. We find objectionable, however, that the subsidy is not available to all financial institutions that make housing loans.

The provisions preventing banks from deducting their carrying costs for new purchases of tax-exempt obligations has been cited as one that will achieve greater equality. Other taxpayers, it is argued, cannot deduct interest if they borrow funds to purchase tax-exempt obligations. Under H.R. 3838, banks would be subject to an absolute disallowance for their interest deduction in direct relationship to their holdings of tax-exempt obligations. Unfortunately, equality will not be achieved. Other financial institutions will continue to be subject to the far less stringent rules of Section 265(2). That section requires the Internal Revenue Service to prove a direct link between the borrowing and the purchasing of tax-exempt obligations. If real equality is wanted, all tax payers should be subject to the automatic disallowance rules of Section 291.

Finally, I would like to mention the issue of equal treatment of products. This became an issue because of the provision in the original Treasury plan to tax the "insider build up" of life insurance policies. While this is not included in H.R. 3838, we would point out how close this product is to a savings account. The interest earned by both the bank account and the insurance policy can be left in to compound, can be taken out, or can be used as collateral for a loan. The interest on the bank account, however, is fully taxable.

The continuing, if not increased, inequalities between financial institutions that would be the result of H.R. 3838 also heightens the need for banking to be able to offer new products and services. If tax policy requires that the tax deferred savings plans that we can offer, such as IRAs, are to be further restricted, then let us have insurance powers so that we too can offer tax deferred annuities. Let us commingle funds so that the 401(k) plans we market can be fully competitive.

Similarly, the negative effects to state and local governments of the provisions blocking us from purchasing new tax-exempt obligations might be greatly alleviated if we were able to underwrite all tax-exempt obligations.

All the major organizations of state and local governments, such as the National Governors Association, National Association of Counties, National League of Cities, U.S. Conference of Mayors, and Government Finance Officers Association have endorsed bank underwriting of revenue bonds. The principal reason for this unanimity is the cost savings which would be realized by state and local governments in future issues of these bonds.

There are several reasons for these savings. First, the added competition may result in lower underwriting fees. Second, bank participation would add liquidity to the secondary market, thus reducing interest costs. Third, bank participation would expose these issues to new investors, which may reduce interest costs by increasing the size of the market. Furthermore, only 11 percent of the revenue bond issues in 1983 were sold through a competitive bidding process, which is generally the lowest cost method of issue. The remainder, over $55 billion of revenue bonds, were sold through negotiated sales. The reverse is true in the general obligation market in which banks do participate, where almost 70 percent were sold through competitive bidding. We believe that allowing bank securities affiliates to underwrite revenue bonds would, by increasing the number of participants, increase the volume of revenue bonds issued under a competitive bidding process, thus reducing the cost to the municipality. In addition, the added competition may result in lower underwriting fees.

Aaron Gurwitz, a senior economist at the Federal Reserve Bank of New York, supported this position in a recent article in the Federal Reserve Bank of New York Quarterly Review. In a discussion of municipal infrastructure financing, Mr. Gurwitz cited allowing banks to underwrite revenue bonds as one significant way to reduce the cost of municipal bonds.

Underwriting revenue bonds by a securities affiliate does not increase risks to banks or bank depositors since banks today may hold revenue bonds in their investment portfolios. Further, this added underwriting authority would not provide banks any unfair advantage over securities firms or permit banks to monopolize the market. This is clear from the general obligation underwriting experience where banks and securities firms compete side-by-side. Banks only have about 50 percent or less of that market and frequently banks and securities firms participate jointly in underwriting syndicates.

CONCLUSION

Mr. Chairman, this represents our views on H.R. 3838, the House-passed tax reform bill. As I indicated above, the American Bankers Association supports the concept of tax reform. The House bill, however, is badly flawed. Many economists have indicated that the bill could cause substantial short term disruption in the economy and reduce gross national product by significant amounts. From the standpoint of a bank, it also contains at least three major flaws. These are the provisions repealing bad debt reserves for large banks, repealing the deduction for interest to carry tax-exempt obligations, and changing the treatment of foreign income. The bill will also heighten the competitive inequities that plague the financial services industry.

We believe that when you analyze the record of these hearings you will reach two conclusions. The first is the need for certain changes in H.R. 3838 to protect legitimate deductions for the safety and soundness of banking. Included within these are the three outlined above. The second is the need for banks to be freed from the artificial restraints that prevent us from offering the full range of products and services that our customers need. Again Mr. Chairman we appreciate the opportunity to testify on this important issue. We would be happy to supply any additional information needed or to answer any questions you may have.

APPENDIX

MEMORANDUM

Re: H.R. 3838 and Income Taxation of Trusts and Estates

Introduction

H.R. 3838 contains provisions for taxing trust and estate income in a substantially different way than under current law or Treasury I or II, which will be referred to as the "Proposal". This memorandum does not take a position on whether the Proposal is an improvement over current law either in specific areas (such as the grantor trust rules) or viewed as a whole. The memorandum does make clear that the Proposal is flawed in significant respects which are both substantive and technical.

Summary of Proposal

All trust income would be taxed at the top rate of tax of 38 percent with four "relief" provisions pursuant to which in certain cases where the grantor or a beneficiary is in a rate bracket below the top rate he may allocate his unused lower brackets to the trust. The distribution deduction (except for any amount of gross income which, pursuant to the terms of the governing instrument, is paid to charity) and the throwback rule would be eliminated. The permitted allocations are:

1. If the trust is a "qualified beneficiary trust", the beneficiary may allocate if age 14 or older or the grantor may allocate if the beneficiary is under that age. For a trust to be a qualified beneficiary trust, income and principal can only be distributed to a single individual during his life and at death the trust property must pass to his estate or be subject to his general power of appointment. An IRC Sec. 2056(b)(7) or 2523(f) marital deduction QTIP trust is also a qualified beneficiary trust.

2. If the trust is a "qualified children's trust", the child or children of the grantor who are beneficiaries ages 14 through 21 may allocate and the grantor may allocate regardless of the ages of the beneficiaries. A trust is a qualified children's trust when income or principal may only be distributed to children or their estates or be subject to a child's general power of appointment (for this purpose, any interest in the trust of descendants of a deceased child is ignored) and no person has a power over the trust which does not satisfy the requirements of IRC Sec.

674(c), relating to powers of independent trustees. A qualified beneficiary trust cannot be a qualified children's trust.

3. Any unused bracket amount of the grantor below the top rate of tax may be allocated by the grantor to any other trust he has created.

4. After the grantor's death a single rate schedule in respect of the grantor may be allocated among his estate and any trusts created by him other than qualified beneficiary trusts or qualified children's trusts. Since the grantor will have no income after his death, the unused bracket amount will commence at zero; the rate schedule used is that of a married person filing separately. For any taxable year beginning on or after the death of the grantor, the run up the rate brackets will be allocated (1) as provided in the decedent's will or (2), if there is no such provision, as provided in an agreement executed within one year of the decedent's death by his executor and the trusts created by the decedent which notify the executor of their existence within nine months of his death or (3), if there is no such agreement, in equal amounts among the estate and such notifying trusts.

The right to use rates below the top rate of tax is dependent upon the trust beneficiary or grantor allocating to the trust unused rate bracket amounts. The allocation is to be made on or before the due date (including extensions) for filing the tax return for the particular year involved and is irrevocable. An individual trust beneficiary under age 14 cannot allocate any unused rate bracket amount to a trust unless both of his parents are dead.

Certain of the current grantor trust provisions would be retained or retained but modified. The grantor would be treated as the owner of any portion of a trust as to which there is (1) a prohibited administrative power, which encompasses the powers referred to in IRC Sec. 675, (2) a current power to revoke held by the grantor or his spouse in favor of the grantor or his spouse or (3) a power to control income - income which is, (i) distributed to the grantor or his spouse or (ii) held or accumulated for future distribution to the grantor or his spouse or (iii) applied to the payment of premiums on insurance on the life of the grantor or the grantor's spouse. IRC Sec. 678, which treats a person as the owner of any portion of a trust with respect to which he has a power to vest corpus or income in himself, is continued.

A husband and wife are separate grantors to the extent they add property to a trust. However, they may elect to treat one of them as grantor on the trust's return for its first taxable year.

An estate would be a separate taxable entity, and, like a trust, would not be entitled to a distribution deduction. A decedent's executor may elect to treat the taxable year of the decedent as continuing to what would have been the close of such year. The consent of the surviving spouse is required for such an election.

Current law would be continued for (1) irrevocable trusts created before September 26, 1985, except to the extent an addition is made to the trust on or after September 25, 1985, and (2) estates of decedents dying before September 25, 1985. Current law would also be continued for foreign trusts, pooled income funds and charitable remainder trusts. The old law is moved and redesignated by increasing its number designation by 10,000.

Comments

A. Substantive

The Proposal would produce a loophole of considerable scope that does not exist under current law. An example will illustrate the point. Let us assume a decedent by his will creates a trust for his only child and directs the income to be distributed currently to the child and the principal to be distributed upon the child's death to his or

her surviving issue. The trust is not a "qualifying beneficiary trust" because the trust property will not be included in the child's estate for estate tax purposes. Thus the trust income will not be taxed by reference to the child's income but rather will be taxed to the trust with a run up the rate brackets below the top bracket. As a result an income tax incentive would exist to create a trust for the child rather than leaving property outright to the child to take advantage of the trust's run up the rate brackets. Even when a family has more than one child, the tax savings may be enticing. The maximum annual tax savings from a run of the rate brackets would be $4,775. The child can act as his own trustee without having the income taxed to him so long as the child is not treated as the owner of the trust under current IRC Sec. 678(a), which is retained in proposed section 653(a).

A credit shelter trust cannot be a qualified beneficiary trust because the property will not be vested in a beneficiary for estate tax purposes and thus the run up the rate brackets will be available even when the spouse is receiving all income of this trust. Thus the Proposal creates an income tax incentive as well as an estate tax incentive for use of such a trust in the form of "split income" to the extent of the trust's income - the spouse can receive the income but the income will be taxed to the trust. Also, an income tax incentive exists after the death of the spouse to keep the property in trust in order to use the run up the rate brackets instead of having the property pass outright to children with other income and be taxed on top of such income.

By retaining IRC Sec. 678, the Proposal creates an untenable distinction between trust beneficiaries who in effect have the same right to income in terms of the taxation of trust income. If a beneficiary is to receive trust income currently, the income is taxed to the trust. However, if the beneficiary is given the right to withdraw trust income annually, the income is taxed to the beneficiary under IRC Sec. 678. See Rev. Rul. 81-6, 1981-1 C.B. 385. Powers of withdrawal may be created in one or more beneficiaries over income or principal. The effect would be to render the Proposal ineffective in denying the current distribution deduction. If desired, the trustee could be authorized to create such powers on an annual basis.

The same problem mentioned in the preceding paragraph exists when the beneficiary of a trust is entitled to interest rather than a share of income. The interest paid to the beneficiary is taxable to the beneficiary and deductible by the estate as would occur under current law for a

distribution of income to the beneficiary. See Rev. Rul. 72-322, 1973-2 C.B. 44; United States v. Folckemer, 307 F.2d 171 (5th Cir. 1062). A beneficiary of a trust created by will may be entitled to interest in Alabama, California, Delaware, District of Columbia, Georgia, Kentucky, New Hampshire, New Jersey, Pennsylvania and West Virginia. In other states the same result may be achieved by a will provision directing that interest rather than a share of income be paid on the unfunded portion of a trust disposition.

If the Proposal is enacted trustees will have to establish and administer tax reserve accounts with which to pay income taxes that under current law are paid by the beneficiary receiving the income and will have to invest this reserve to produce income. Time problems will occur in connection with the filing of calendar year trust income tax returns because the grantor or designated beneficiary will not make an allocation until his or her return is prepared, which usually will be shortly before, or, in many cases, after the trust return is due to be filed because the individual has obtained an extension of time to file.

A necessary consequence of the Proposal is the reduction of charitable contributions because trust income received by a beneficiary would not be included in his or her income in computing how much he or she could contribute and receive an income tax deduction for the contribution. However, the Proposal would for the same reason put a trust income beneficiary in a preferred position in terms of medical expenses that may be deducted for income tax purposes.

An allocation of an individual's unused rate bracket amounts may be made to a child of the individual under age 14 as to parental source income (see proposed section 1(g)(5)) as well as to some trusts created by the individual. The rules for qualified beneficiary trusts and qualified children's trusts seem wrong. In the case of a qualified beneficiary trust, the rule is the grantor can allocate if the beneficiary is under age 14. This is correct if the grantor is a parent of the beneficiary but is incorrect and inconsistent with the policy behind the taxation of a qualified beneficiary trust when the grantor is another person, in which event no allocation by the grantor should be permitted. For a qualified children's trust, where the grantor must be a parent, no restriction is placed on an allocation by the grantor. No sound reason exists for a rule different than that for a qualified beneficiary trust and for a non-trust allocation to a child. Accordingly, the rule should be that the grantor can allocate only if a beneficiary is under age 14.

The rule for the beneficiary's allocation of his

unused rate bracket amounts also seems wrong for both a qualified beneficiary trust and a qualified children's trust. For a qualified beneficiary trust, the beneficiary should be able to allocate in any case where the grantor cannot allocate as provided in the preceding paragraph. Thus, where the beneficiary is a grandchild of the grantor, the beneficiary could allocate to the trust. For a qualified children's trust, any child over age 14 should be able to allocate even though the child is over the age of 21. The interest of each child is sufficiently "vested" so that the treatment should be the same as for a single child with a qualified beneficiary trust.

Proposed section 642(d)(2) defines a "qualified beneficiary trust". Paragraph (2)(B) places certain limitations upon what persons can have discretionary powers over the trust property, which are that "except as provided in subparagraph (A)(ii)" no person holds a power which does not meet the requirements of current section 674(c). The paragraph is both unnecessary and flawed. Given the "vested" nature of children in the trust, no limitation is needed. If the income is used for a support obligation of the grantor, proposed section 652(d)(2) will apply. If the grantor is dead why should not a family member be able to act as trustee? Also, the "except" clause quoted above creates an untenable distinction between distributions during the trust term (covered by (A)(i)) and distributions at termination (covered by (A)(ii)). As drafted, discretion during the term is "bad" (invokes current section 674(c)) while discretion at termination has no significance. Such a distinction is untenable.

As noted above, certain of the current grantor trust provisions would be retained or retained but modified. These provisions are current IRC Secs. 675, 676 and 677. The result of the application of these provisions is that trust income would be taxed to the grantor. The Proposal's general rule is that trust income is taxed to the trust, but at the grantor's marginal rate during the grantor's life. Thus, the retained current grantor trust provisions and the "general" rule produces the same tax but differ in the source of payment of the tax. Further simplification would be obtained by eliminating the current grantor trust provisions entirely from the Proposal, with perhaps a single exception for a trust which is wholly revocable by the grantor. This simplification would also prevent the grantor from intentionally invoking the grantor trust rules in order to permit himself to make a tax-free gift in the form of the income taxes on the trust income. This could be done under the Proposal by giving his spouse the power to revest the trust property in the grantor.

A reason for retaining the current grantor trust provisions as modified may be retain the tax treatment of unit investment trusts and similar investment vehicles. This objective could be achieved by a specific provision which would refer to the 10000 sections and make them applicable to:

> a trust which (a) is organized for investment purposes, under a trust indenture, contract of custodianship or agency or similar instrument, (b) does not have a board of directors, and (c) issues securities, each of which represents an undivided interest in the property of the trust.

Proposed section 645(a) captioned "Status of Certain Income Clarified" is taken from IRC Sec. 641(a) and states the income to which the tax applies "shall include" certain types of income. Income collected by "a guardian of an infant which is to be held or distributed as the court may direct" is mentioned. Taxing such income as a trust (even though the trust should be a qualified beneficiary trust) rather than to the infant seems wrong. More important, income from property subject to a legal life estate is not referred to, thus suggesting that such income is taxed to the life tenant. This result is inconsistent with the policy behind the qualified beneficiary trust concept.

The Proposal should describe how spouses are to allocate their unused rate bracket amounts where trusts are created by each of them and a joint income tax return is filed.

The allocation of the single run up the rate brackets after the grantor's death among his estate and trusts he has created is unclear in several respects. As noted above, unless the decedent makes an allocation in his will or an agreement is reached, his estate and all notifying trusts will share equally in the allocation. The estate will go out of existence at some time. When this occurs the estate's allocation should pass to the notifying and existing trusts. Similarly when a trust terminates, its allocation should pass to the other notifying and existing trusts. Some method of changing the allocation is needed. No guidance is given as to what the decedent's will or the agreement may provide. May the decedent give an individual the right to make the allocation on an annual basis? May the agreement say that the estate and notifying trusts will make the allocation on an annual basis?

Since any agreement must be executed by the decedent's estate and all notifying trusts, each of these entities has the right to prevent an agreement and obtain an equal benefit from the allocation. Rather than requiring an agreement by all of the estate and such trusts, a better and more direct approach would be to permit the estate or any

such trust on an annual basis to use his benefit or to give all or any part of it to any other entity entitled to an allocation in the absence of an agreement.

With qualified beneficiary trusts, the tax reduction resulting from the use of the beneficiary's unused bracket amount may be less than that resulting from use of the grantor's rate brackets after his death. By definition a trust qualifying for the estate tax marital deduction must be a qualified beneficiary trust. Why shouldn't the trust be permitted to use the run up the rate brackets if an income tax savings is produced? The Proposal does not permit its use. So long as the funding of the marital trust from an estate or revocable trust is postponed, the run up the rate brackets is available to the estate or trust.

The beneficiary of a qualified beneficiary trust is treated as the grantor of the trust after his death. This result seems wrong in the case of a QTIP trust because the beneficiary may have no control over the disposition of the trust property and the spouse's run up the rate bracket is not fully available to trusts she creates.

Under current law a deduction is permitted under IRC Sec. 642(c) for amounts of estate income "set aside" for charity. Thus, if an estate passes solely to charity no tax is paid on its income. The Proposal does not permit this deduction. This seems wrong. A "set aside" deduction should also be available for a trust, including a revocable trust that serves as a will substitute. Also, the requirement that charity receive the income "pursuant to the terms of the governing instrument" should be modified. In Trust of John Walker, 30 T.C. 278 (1958), the court held trust income distributable to charity pursuant to the exercise of a testamentary power of appointment did not satisfy this requirement. The result should be changed by adding the words "(including the exercise of a power of appointment)".

Proposed section 644(a) states that no amount shall be included in the gross income of any beneficiary by reason of any estate or trust distribution including a charity. This result changes current law under IRC Sec. 4942 for a distribution to a private foundation. See Treas. Reg. §53.4942(a)-2(b)(2).

The Proposal "grandfathers" trusts that were "irrevocable" on before September 25, 1985 by continuing to apply current law to them. Fairness compels this result because the change is so different from current law. The administrative cost of a dual system is substantial. Two radically different methods of taxing trusts must be learned by persons filing trust income tax returns for a long period of time.

The legislative history is not helpful in giving the important word "irrevocable" a clear meaning. The same term is used in the effective date provisions of Chapter 13, relating to the tax on certain generation-skipping transfers. The legislative history should state whether the same or a different meaning is to be given to the word. See Treas. Reg. §26.2601-1.

The Proposal states that if any amount is added to a grandfathered trust after September 25, 1985 the amount of the addition will be subject to the new rules. Thus, a partial taint rule is proposed. Additions will be made and cannot be avoided because they are required by the terms of existing trusts. This will often occur when marital deduction trusts are added to other trusts after the death of the surviving spouse and with existing life insurance trusts which hold ordinary or term insurance and additions are made to pay premiums. Guidance is needed as to how the partial taint rule would be applied. Also, since the two sets of rules are so different - one permits a distribution deduction and the other does not - the only satisfactory way of applying the rules is for the trustee to administer the single trust as two trusts, which will result in increased administrative costs.

B. Technical

The following technical issues arise under the Proposal:

1. The definitions of a qualified beneficiary trust and a qualified children's trust use the words "such beneficiary [child] may appoint under a general power of appointment (as defined in section 2514(c)". This definition is different from the general power which is required for marital deduction purposes under IRC Sec. 2523(e) or 2056(b)(5), thus suggesting that a power to consume which is not limited by an ascertainable standard is sufficient for a qualified trust. The preferable approach in terms of "certainty" is to use the marital deduction definition. A qualified children's trust refers to "one or more" children having a general power of appointment and is unclear whether upon the death of a child prior to the termination of the trust that child's interest must pass to his estate or be subject to a general power of appointment. Read literally, the answer is no and the last surviving child may be given a "continual" general power.

2. If the definition of a "qualified beneficiary trust" in proposed section 642(c)(2)(A) is given its plain meaning, a trust will not satisfy the requirements in the year of the beneficiary's death - because thereafter

payments can be made to other beneficiaries. Is this result intended?

A QTIP trust is, under proposed section 642(c)(2)(B), treated as a qualified beneficiary trust until "the termination of the spouse's interest in the trust". When this termination occurs as a result of the spouse's death is unclear and should be clarified. In deciding the appropriate time, account should be taken of proposed section 661 and an election being made to continue the taxable year of the decedent. Also, the termination rule of paragraph (2)(B) must be coordinated with the grantor-beneficiary rule of paragraph (2)(C), which is not clear regarding when grantor status commences.

3. Spouses are different grantors and trusts created by each grantor are entitled to the use of the grantor's run up his rate bracket. Since outright gifts to the spouse of a donor or decedent qualify for a gift tax or estate tax marital deduction, thus permitting the other spouse to be the grantor, a donor or decedent should be permitted to give a part or all of his run up the rate brackets to his spouse without the necessity of making an outright transfer to accomplish this result.

4. Proposed section 646(a)(4) authorizes an individual to allocate his unused rate bracket amounts to a

child under age 14. Since subpart A relates to the taxation of trusts and estates and not individuals the placement of this provision seems wrong. Assuming the significance of this allocation is limited to unearned income of a child attributable to parental sources, the appropriate place is in proposed section 1(g).

5. If an election is made to continue the taxable year of the decedent under proposed section 661 all items of income, deduction and credits which would have been taken into account by the estate shall "be taken into account" on the decedent's return. The meaning of these words in terms of distributions to charity under proposed section 643(b) is unclear. Is the decedent's percentage limitation applicable? The effect of the election appears to be that gains and losses of the estate, taking into account the basis change at death, for the balance of the calendar year of death are merged with the pre-death gains and losses of the decedent and with the gains and losses of the spouse for the entire year. Is this intended?

6. Proposed section 645(b)(2) permits a husband or wife who make transfers to a trust to elect to treat one of them as grantor and states the election shall be made on the return for the trust's "1st taxable year". If transfers are made in later years is the election for the first year binding on them or may a different election be made?

7. Proposed section 665 relates to the exemption amount for minimum tax of trusts and estates. The heading of subsection (a) refers to "certain trusts" after the death of the grantor. The first sentence refers to "trusts taxable under section 641(b) with respect to which a decedent is the grantor." This language is broad enough to cover all trusts created by a decedent-grantor. However, subsection (b) also covers some of these trusts. The overlap should be eliminated. This could be accomplished by adding the words "(other than trusts referred to in subsection (b))" after the word "grantor" in proposed section 665(a).

8. Proposed section 665(b)(2) relates to the allocation of the minimum tax amount among trusts described in proposed section 665(b)(1). Paragraph (2)(A) states that an individual who may make an allocation of an unused rate bracket amount pursuant to section 646 "may" allocate a part of his exemption amount to the trust. Paragraph (2)(B) creates an irrebutable presumption - the words "shall be treated" are used - that an allocation of an unused rate bracket amount pursuant to section 646 causes a proportionate part of the exemption to be available for the trust. Paragraph (2)(B) should be modified.

9. IRC Sec. 691(c)(B) relates to the allocation of the deduction for estate tax attributable to income in

respect of a decedent between trusts and estates and their beneficiaries. The disallowance of a distribution deduction under the Proposal requires that this provision be amended.

10. IRC Sec. 167(h) relates to the allocation of a depreciation deduction in the case of life tenants and income beneficiaries of trusts and estates and should be amended because of the disallowance of a distribution deduction under the Proposal.

11. IRC Sec. 678(c) and (d) are repealed. Subsection (c) states that subsection (a) shall not apply to a power held as trustee to apply trust income to the support or maintenance of a person whom the holder is obligated to support except to the extent so applied. The first sentence of subsection (c) should be retained unless the legislative history deals with the issue and the result intended by eliminating the subsection. Subsection (d), relating to the disclaimer of a power, seems unnecessary.

12. IRC Sec. 1361(d), relating to a qualified subchapter S trust, must be amended to change the references to section 678(a) and section 643(b). The references should be to section 653 [or 10678(a)] and to section 10643(b).

13. Proposed section 1(g)(4)(ii)(I), relating to a qualified segregated asset, should be amended to refer to the first return required after the asset was acquired.

14. Proposed section 67(b) is erroneous in failing to exclude the deduction under proposed section 643(b)(1) for distributions to a charity in determining itemized deductions.

APPENDIX

MEMORANDUM

Re: H.R. 3838; Generation-Skipping Transfers

H.R. 3838 contains a replacement for current Chapter 13 which imposes a transfer tax on certain generation-skipping transfers. This memorandum does not take a position on whether the replacement is an improvement over current law or better than the Treasury Chapter 13 simplification proposal. It does make clear that the H.R. 3838 replacement is deficient in significant respects which are both substantive and technical.

1. Section 2603(b) relates to the source of payment of the tax and creates the general rule that the tax be charged to the property constituting the generation-skipping transfer. However, this rule applies only when the transfer is "from a trust". An untenable distinction is created between wills and certain trusts. To illustrate, a direct skip by will would not be subject to the general rule, but a direct skip from a revocable trust would be subject to the rule.

2. Section 2604(a) allows a credit against the tax for a generation-skipping tax paid to a state. The credit applies only if the transfer "occurs at the same time as and as a result of the death of an individual". These words cover direct skips as well as taxable terminations. See sections 2624(c) and 2661(2), the amendment of section 691(c)(3) and the amendment of section 6166.

3. The word "mean" in the second line of section 2611(a) should be "means".

4. The word "grantor" in the last line of section 2611(b)(1) should be changed to "transferor".

5. Section 2612(a)(2) provides as follows:

> CERTAIN PARTIAL TERMINATIONS TREATED AS TAXABLE. - If, upon the termination of an interest in property held in a trust, a specified portion of the trust assets are distributed to skip persons who are lineal descendants of the holder of such interest (or to 1 or more trusts for the exclusive benefit of such persons), such termination shall constitute a taxable termination with respect to such portion of the trust property.

This provision was not in H.R. 6260. Its purpose may be to make clear that a taxable termination is "preferred" over a taxable distribution. The provision seems unnecessary and is confusing in its limitation to a case where the distributees are descendants of the individual with the terminating interest. Why shouldn't the result be the same where the distributees are other skip persons?

6. Section 2612(b) defines a "taxable distribution". Read literally, the definition could apply to a transfer which is a "direct skip" such as a transfer to a

grandchild of the grantor of a revocable trust. The words "or a direct skip" should be added after the last word "termination".

7. Section 2612(c)(1) requires for a direct skip a transfer subject to tax under chapter 11 or 12. This definition means a direct skip can occur only when an estate or gift tax is imposed on the transfer. Thus, for example, if a taxable termination takes place at the death of a child who appoints the property outright or in trust for his grandchildren no direct skip will occur. A different result is not required by section 2653 relating to the taxation of multiple skips. What result is intended may be uncertain since an outright transfer to a great-grandchild of the transferor produces only one tax. If section 2612(c)(1) is modified to treat such an appointment as a direct skip, section 2653 needs to be changed to move the transferor down another generation.

8. Section 2612(c)(2) contains a special rule for determining whether a transfer is a "direct skip" that applies in a predeceased child case. The effect is to treat a grandchild of the transferor or of the transferor's spouse as a child of the transferor, thus preventing a direct skip. The class should be expanded to include a grandchild of a former spouse of the transferor. Also, in paragraph (2)(B) the word "child" should be substituted for "lineal descendant".

More important, the rule should not be limited in scope to determining whether a direct skip has occurred. For example, if a child of a deceased child of the transferor who died before the transferor is a beneficiary of a discretionary credit shelter trust for the surviving spouse and descendants, distributions to this grandchild should not be treated as taxable distributions. Without this exception the tax is not neutral in treating outright and transfers in trust in the predeceased child case. Where a child of the transferor dies before the creation of the trust, the children of the deceased child should, in non-direct skip cases, be treated as children of the transferor in determining whether a taxable distribution has been made and in determining whether a taxable termination occurred to the extent the termination requires a distribution to them.

9. Section 2612(c)(3) creates a $2 million special exemption from a "direct skip" for a transfer "to" a grandchild of the transferor. The statute should be revised to "interpret" this word in the same way the grandchild exclusion under current law has been interpreted in the proposed regulations - a transfer in trust is eligible for the exemption if during the grandchild's life no distribution

can be made to any other person and the trust property must pass outright to the grandchild or be included in the grandchild's estate for estate tax purposes.

10. The words "For purposes of this chapter", at the beginning of section 2621(a), section 2622(a) and section 2623 should be stricken as unnecessary.

11. Section 2624(c) permits the use of the alternate valuation date method of current section 2032 to be used for taxable terminations for a trust occurring at the same time as and as a result of the death of an individual. The words "or distributions" should be added after the words "taxable terminations". Also, the legislative history should make clear each trust may make the election independent of any other trust.

12. Section 2631(a) permits an individual to allocate his GST exemption to "property transferred at any time by such individual." Read literally, this permits the exemption to be allocated to marital deduction trust property irrespective of who is the transferor after the spouse's death. See section 2652(a) for the definition of "transferor". Is this result intended?

13. Section 2631(b)(2) should be revised to refer to a deemed allocation made pursuant to section 2631(b)(1).

14. The application of section 2642, relating to

the inclusion ratio, is unclear when the transferor retains interests in property he transfers in trust. This would occur where the transferor retains an income interest for a term of years or for life. Under subsection (a)(2)(B) the denominator of the applicable fraction is "the value of the property transferred to the trust." Is this the full value of the transferred property or this value reduced by the value of the retained income interest? In this connection, the language of subsection (a)(2)(B) is slightly different from section 2642(d)(2)(B), relating to multiple transfers to a trust.

15. If an individual makes a direct skip during life and does not "elect out", any unused portion of his GST exemption is allocated to the property transferred pursuant to section 2632(b)(1) and gift tax values are used. The manner and time within which an election out must be made should be described in section 2632(b)(3).

16. Section 2642(c)(3) defining a "nontaxable gift" should be revised to substitute the word "section" for "subsection". See proposed section 2642(d)(1).

17. H.R. 6260 permitted any portion of an individual's GST exemption which was not allocated to his taxable transfers to be transferred to his surviving spouse. H.R. 3838 does not do so. As a result an estate owner with

a surviving spouse may have to pay an estate tax at his death in order to make full use of his exemption. For example in 1987 the unified credit will protect transfers of $600,000 from estate tax. Most substantial estate owners will desire to create a maximum amount credit shelter trust and qualify the balance of the estate for the marital deduction. However, such a disposition would cause the loss of $400,000 of his exemption, which could be used if the credit shelter trust is increased by $400,000. An estate owner should not be put to this choice.

Section 2652(a)(3) states that a decedent or donor spouse may elect to treat QTIP property as to which an election has been made as if the election had not been made. This solves the problem mentioned in the preceding paragraph as to one type of marital deduction disposition, but why should a distinction be created as to any type of marital trnasfer? The approach of H.R. 6260 is preferable. Also, section 2652(a)(3) appears to require an election "out" of all QTIP. This election should be permitted as to any part of QTIP.

18. Section 2653 produces the wrong result where a direct skip is made in trust for great-grandchildren and more remote descendants. The transferor should be moved down two generations. If this is not done, a distribution to a great-grandchild would be a taxable distribution.

At best the words "(other than section 2651)" are uncertain in their meaning and at worst the words produce wrong results.

19. Section 2654(a)(1) contains a general basis adjustment for property included in generation-skipping transfers and uses the words "the basis of such property in the hands of the transferee." The term "transferee" is not defined. No useful purpose exists for this term. The words "in the hands of the transferee" should be stricken. H.R. 3838 creates an income tax deduction for the GST tax imposed on income distributions. This tax is defined as the tax imposed by section 2601 and any State tax described in section 2604. A distinction should not be created between the basis adjustment and the income tax deduction. Section 2654(a)(1) should be modified by substituting "and any State tax described in section 2604" for "(computed without regard to section 2604)".

20. Section 2662(a)(1) provides that the person required to make a Chapter 13 return is the person liable for the payment of tax. Under section 2603(a) the trustee pays the tax on a direct skip from a trust. Under section 2662(a)(2)(A) the time for filing a return on a direct skip from a trust is based upon the filing date of the estate or gift tax return reporting the transfer. A preferable

approach would be to apply section 2662(a)(2)(B) in the case of such a direct skip since the person filing the return is not the person filing the estate or gift tax return reporting the transfer.

21. Current section 303(d) is amended. This provision should apply to the tax on a direct skip.

22. Amended section 691(c)(3) creating an income tax deduction for the Chapter 13 tax on items of gross income should be revised to strike the words "of the trust" after the words "gross income" are first used. The gross income may not be included in the trust's income but rather be included in the gross income of the transferee. For example, accrued interest on bonds may be included in the Chapter tax on a taxable termination but the bonds may be distributed to a transferee before the next interest payment is made.

23. Section 2032(c)(2), relating to the use of the alternate valuation date, is amended to refer to the Chapter 13 tax on property included in the decedent's gross estate. For this to occur a direct skip must occur. The statute should be amended by inserting the words "on a direct skip as defined in section 2612(c)" after "chapter 13".

24. Current Chapter 13 contains a charitable deduction provision in section 2602(c)(2). The changes in

H.R. 3838 do not contain such a provision, but deal with the subject indirectly in the definition of "non-skip person" in 2613(b) and "interest" in section 2652(c)(1). A charity is a "non-skip person". Accordingly, a taxable termination will not occur when immediately after a beneficiary's interest terminates a charity has an interest in trust property. The charitable interest may be mandatory such as an annuity amount, a unitrust amount or an income interest or may be discretionary. With regard to charitable remainder interests, the definition of interest in section 2652(c)(1)(C) means that a charitable remainder interest will also prevent a taxable termination. However, in the case of such interests all distributions to beneficiaries assigned to generations two or more generations below the transferor will be treated as taxable distributions. Section 2652(c)(2) provides that an interest which is used primarily to postpone or avoid the Chapter 13 tax will be disregarded. Although the proposed rules are significantly different from section 2602(c)(2) of current law, they appear workable except perhaps in the case of a discretionary charitable interest which will raise the question of whether the interest is nominal. If the interest is not nominal, no taxable terminations will occur but distributions to individuals two or more generations below the transferor will be taxable distributions.

25. The effective date rules in section 2213 are inadequate in failing to create an exception in (b)(2) for cases covered in (B)(i) when the decedent dies prior to the date of enactment, irrespective of any mental disability.

The Chairman. Mr. Backlund.

STATEMENT OF B.F. (CHIP) BACKLUND, PRESIDENT, BARTONSVILLE BANK, PEORIA, IL; PRESIDENT, INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Mr. Backlund. Mr. Chairman, I'm Chip Backlund, president of the Independent Bankers Association of America, representing some 7,400 community banks. I am also president of the Bartonsville Bank, a small bank near Peoria, IL.

We have a written statement and I will paraphrase from that in the interest of time.

[The complete prepared statement follows:]

T E S T I M O N Y

of

B.F. (Chip) Backlund
President
Bartonville Bank

Peoria, Illinois

and

President

INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Hearing on Tax Reform (H.R. 3838)

Before the
Committee on Banking, Housing and Urban Affairs
Honorable Jake Garn, Chairman

Washington, D.C.

February 5, 1986

Mr. Chairman, my name is B.F. (Chip) Backlund and I am president of the Independent Bankers Association of America (IBAA), a national trade association representing over 7400 community banks. I also serve as president of the Bartonville Bank, a $36 million bank near Peoria, Illinois.

The IBAA appreciates the opportunity to participate in today's hearings on tax reform in general and on H.R. 3838 in particular. As you know, the President's tax reform proposal and the budget balancing requirements of the Gramm-Rudman-Hollings bill have set in motion a number of competing interests that will increase pressure to raise additional tax revenue. Therefore, it is most fitting that this Committee, and you, Mr. Chairman, would hold these hearings to explore the impact that the House-passed tax bill, H.R. 3838, would have on the safety and soundness of the nation's financial institutions.

Our Association supports the public policy goals underlying H.R. 3838--to simplify the nation's tax laws and to make our tax system more efficient and equitable. Notwithstanding these laudable goals, there are certain provisions in H.R. 3838 which would have a seriously adverse impact on the safety and soundness of the nation's banking industry. In particular, I refer to provisions which would repeal the special Net Operating Loss (NOL) carryover rules for financial institutions, drastically reduce banks' deductions for loan loss reserves, and require most banks to convert to accrual, rather than cash, accounting.

Over the past ten years, banking has undergone an extensive period of product and geographic deregulation. These forces have combined to make banking a more competitive and risk-sensitive industry than it used to be. It is questionable whether it would be appropriate, at this time, to take steps that would hinder banks' efforts to reduce the potential adverse impact of this additional risk. At a time when bank failures are at record levels and over 1,100 banks are on the regulators' problem bank list, Congress needs to consider carefully the potentially harmful side-effects which these tax proposals could have on troubled banks in particular. In addition, at a time when credit unions and thrift institutions are competing directly with commercial banks and yet benefit from significantly lower taxes or no taxes at all, Congress should take care to impose equal tax burdens on these various types of institutions that compete directly with each other.

The following are several of the proposed tax measures which are of greatest concern to independent bankers across the country:

NET OPERATING LOSS (NOL) CARRYOVER

Current NOL rules for financial institutions allow banks to apply net operating losses to their tax liability as far back as 10 years and as far forward as 5 years. This ability to "carry over" losses can often be the difference between continued operations and failure for a marginal bank. Community banks, especially agricultural banks, tend to lend heavily in their localities and therefore may have large exposure to a single economic sector that predominates in their locality or region. When that sector experiences an economic downturn, it can mean extraordinary losses for many banks in the region. Without sufficient tax carryovers, these losses can cause a bank to fail by reducing its capital below the regulators' minimum acceptable level.

For example, Bank A, a small IBAA-member bank located on the western slope of Colorado with a majority of its loans concentrated in oil shale exploration and other natural resources, suffered a large net operating loss in 1982 of $1,671,301. The main reason for this loss was loans charged off as a result of a major oil corporation's withdrawal from oil shale activities in the region, which, in turn, was caused by depressed worldwide oil prices.

By utilizing the NOL provisions contained in current law, the bank was able to go back 7 years to partially recoup the loss through a $737,402 tax refund (Exhibit I). The bank's ratio of primary capital to total assets without the loss carryback would have been approximately 3.6% (Exhibit II). The tax refund immediately improved the capital position of the bank and brought the ratio of capital to total assets to an acceptable 5.9% level. Thus, the 10-year net operating loss carryback provision in this case allowed the bank to convert its losses into earning assets immediately and to cushion the blow from a sizeable loss. It is highly likely that this bank would have been closed in 1982 due to a substandard capital ratio of 3.6%. However, due to the refund generated by the NOL carryback, the bank was able to stay open and today is a healthy, viable institution.

A second example is Bank B, an agricultural bank located in a western state, which suffered even more substantial losses in 1980. The bank lost $3,219,557 due to bad agricultural loans and customer fraud. As a result of the 10-year net operating loss carryback, the bank was able to offset $1,750,412 in losses, or 54.4% of the total loss it had suffered in a single year. This generated a tax refund of $702,299, and improved the bank's capital to assets ratio from 1.49 percent to 4.28 percent (Exhibit IV). What is interesting about this particular bank is that even the 10-year carryback provision was insufficient to make up for the remaining loss of $1,469,145, an amount which the bank may or may not have been able to recoup in additional NOL carry forwards over the next 5 years. As in the first example, the NOL provision enabled this bank to meet the regulator's minimum capital requirements, which, in turn, helped the bank to obtain new financing and remain open.

These examples illustrate some of the advantages of the 10-year loss carryback provision:

a) Net operating loss carrybacks immediately generate current tax benefits to banks by providing direct cash flow and improving their ratio of primary capital to total assets. In this way, the 10-year carryback period is far more beneficial than a carry forward period of 10 years.

b) By converting the tax benefit from a loss carryback to earning assets, there is an increase in the revenue-earning capacity of banks and their potential taxable income in the future.

c) Without the loss carryback provision, small banks across the country would not have the necessary tax cushion or reserve against large unforeseen losses that occur in a particular tax year.

It is imperative that the 10-year net operating loss carryback period be maintained, especially for agricultural banks. The present condition of the agricultural economy in the Midwest and Rocky Mountain regions could result in an avalanche of loan losses for agricultural banks due to a decrease in land values pledged as collateral on loans. Without the special NOL rules, the credit crisis in these areas will undoubtedly worsen.

In fact, the current law on NOLs is inadequate to provide the kind of "stretch-out" period needed by agricultural banks. The Banking Committee has recognized the need for additional help by agreeing to schedule hearings in the near future on possible regulatory and legislative steps which would enable banks to amortize their agricultural loan losses over an extended period of time, rather than being forced to recognize their entire losses in a single year. It would be inconsistent and counterproductive for the government to assist agricultural lenders and farmers with this or other "workout" measures while, at the same time, restricting commercial banks' use of similar NOL provisions.

The revenue implications for this provision are very small. According to the Ways and Means Committee report on H.R. 3838, repeal of the NOL rules for financial institutions would increase government receipts by less than $5 million annually. This cost would be more than offset by the cost of closing down marginal banks that might not be able to survive without the current NOL carryback provisions.

LOAN LOSS RESERVES

The ability of financial institutions to reserve funds against possible loan losses is equally vital to the safety and soundness of the banking industry. These reserves also have a direct impact on the financial system as a whole. Without such reserves, banks would be in a much weaker position to withstand sudden losses and widespread recession and our national economy will be weakened.

Historically, the federal tax laws have recognized the unique importance of bank's loan loss reserves by allowing them to use the "percentage method" to calculate the allowable deduction. Over the past 10 years, the maximum percentage allowed under this method has declined, and now stands at only 0.6 percent of eligible loans in 1986 and zero percent after December 31, 1987.

Total elimination of the percentage method would constitute one of the most short-sighted and reckless tax "reform" acts that Congress could enact and might eventually have widespread adverse economic consequences. We already find that the current 0.6 percent level is serving as a distinct disincentive for financial institutions to maintain healthy levels of loan loss reserves. Furthermore, at a time when the banking agencies are encouraging banks to boost their overall capital ratios and to increase loan loss reserves, it is inconsistent for the Treasury Department to be moving in the opposite direction by making it more costly and burdensome for banks to maintain these reserves.

The IBAA strongly supports retention of the percentage method for community banks. In addition, we favor an increase in the currently allowable deduction to a level more in line with regulatory requirements and the establishment of a permanent fixed percentage which doesn't change with each new Congress.

Under H.R. 3838, the reserve method of accounting for loan losses would be repealed for all banks over $500 million in assets but the "experience" reserve method would be retained for all banks under that size. We would like to see the percentage method retained for all banks, regardless of size, at a higher level than the current 0.6 percent. However, with so many smaller banks in our agricultural heartland suffering severe economic stress, it is absolutely essential that, at a minimum, the nation's smaller banks be allowed to continue using the reserve method provided for in the House bill. It is only fair that community banks should be granted such latitude, since they have historically paid a significantly higher effective tax rate than the money center banks.

CASH-ACCRUAL ACCOUNTING

The House bill requires all businesses to report on an accrual basis, except for small businesses with under $5 million in "gross profits." These small businesses, including banks, can continue to use cash accounting. The IDAA urges that this exemption for small banks be retained in the Senate bill.

We estimate that roughly half of all small banks use the cash method for tax reporting purposes. This is done for several reasons. First, it is simpler and involves far less paperwork and accounting costs. Second, it serves as another mechanism by which small banks can set aside an additional reserve for possible loan losses and can recognize income when they can best afford it.

Cash accounting serves as a means of protecting the safety and soundness of a commercial bank, without a significant revenue loss. For example, Bank C is an $18 million bank located near Peoria. During the last few years, there have been 28,000 jobs lost in the Peoria area as a result of closed plants and layoffs at Pabst, Heister, Wabco, International Harvester, Caterpillar Tractor Company, and Hiram Walker. Real estate values declined rapidly as 6000 homes flooded the marketplace when the unemployed work force could not make their payments. Bank C had an excellent track record in lending until 1980, as shown in Exhibit V. Since 1980, loan losses have exceeded $575,000. Losses in each of the last two years have exceeded 2% of outstanding loans, which is well above the national average.

Bank C's management had been aggressive in using tax planning in this small bank over several years to build up a reserve for this type of unanticipated risk. As you can see from the attached Exhibit V, loan losses increased almost ten times from 1979 to 1985. By using the cash method of accounting over several years, the bank had accumulated an additional reserve of $163,000 by 1985, an amount which helped the bank weather its large losses in 1984 and 1985. If the bank had been compelled to use the accrual method, none of this $163,000 would have been available as a cushion and the bank might not have survived.

DENIAL OF DEDUCTION FOR CARRYING TAX EXEMPT BONDS

Under current law, banks holding tax-exempt municipal securities are denied a deduction for 20% of the interest expense attributable to carrying such securities. H.R. 3838 increases this disallowance to 100% but adds a temporary "small issue" exemption. Under this exemption, "public purpose" bond issues of $3 million or less, sold by an issuer who offers no more than $10 million in tax-exempt bonds in a single year, could be sold to banks that are licensed to do business in the state of the issuer. Under these limited circumstances, the bonds would be eligible for the 20% denial instead of 100%. This exemption would expire after three years.

The IBAA is concerned that such a disallowance signals a "back-door attempt" to tax banks' purchases of traditionally tax-exempt bonds. Tax-exempt bonds are vital to municipalities, which market a large percentage of their bonds to commercial banks. Denying the tax-exempt status of bonds held by banks will undoubtedly reduce banks' participation in this market. If that happens, yields on tax-exempts will rise, causing municipalities' cost of financing public projects to increase substantially.

Municipal securities have traditionally been exempt from federal taxation and the IBAA urges that this principle be retained in any tax reform package. However, we do realize the predicament of the small towns in America that may not be able to float a bond issue at any cost if local banks are not able to buy at least part of the issue. We therefore also recognize that the small issue exemption, if made permanent, would serve to reduce the adverse impact of this provision on rural communities.

H.R. 3838 is particularly unfair because it changes the tax-exempt status of municipal securities already held by banks. The House bill applies to all bonds acquired after the effective date contained in the bill. This is unfair, because it changes the rules in mid-stream. Hundreds of banks bought these bonds with the expectation that they could sell them to other banks if they needed to. Therefore, the effective date should be changed to "issued after" instead of "acquired after." Purchasers of bonds issued after the effective date would be certain of the tax consequences attendant upon their purchase.

INDIVIDUAL RETIREMENT ACCOUNTS

The House bill severely cuts back the availability of IRAs by linking the maximum amount that an individual can contribute to an IRA to the maximum amount that he or she has contributed to a 401K plan. Simply put, once someone contributes $2,000 to a 401K plan, he or she loses the opportunity to contribute any additional amount to an IRA during that year.

The IBAA opposes this limitation. IRA accounts are currently available to all taxpayers regardless of the fringe benefits (e.g.

401K plans) that they receive from their employers. The issue of taxation of fringe benefits should be kept separate and distinct from such individual savings devices as IRAs. With the personal savings rate in America at an all-time low, the IBAA urges Congress to increase, not decrease, the amount of permissible contributions that taxpayers can make to their IRAs.

CREDIT UNION TAXATION

H.R. 3838 leaves intact the tax-exempt status of credit unions. The IBAA strongly believes that this is an inequity that should be rectified. Credit unions, which have had broad bank-like powers since 1980, present strong and unfair competition to banks--particularly small banks--because they pay no taxes and are not subject to the same regulatory requirements which banks must satisfy.

More and more, credit union charters are being granted on the basis of a geographic area rather than any common bond. Why should people who simply live within 50 miles of each other get a special tax break? These credit unions are advertising for, and getting, the accounts of the general public. If credit unions are going to act like banks, it is unfair that they should remain tax exempt.

In conclusion, thank you again for allowing us to participate in these hearings. I would urge all Members of this Committee to share these important safety and soundness concerns with the Senate Finance Committee in their upcoming deliberations.

Bank A
Actual Tax Refunds From the 10-Year Net Operating Loss Carryback

EXHIBIT I

	Federal Taxable Income	Federal NOL Carryback	Tax Refunds Federal
1969	$ 27,295		$ 1,150*
1970	47,295		373*
1971	55,947		713*
1972	97,270	$ (97,270)	39,735
1973	88,612	(88,612)	37,161
1974	223,887	(223,887)	101,753
1975	119,263	(119,263)	43,708
1976	62,563	(50,778)	14,087
1977	314,199	(314,199)	136,435
1978	528,459	(528,459)	225,703
1979	618,743	(248,833)	136,584
1980	804,830		
1981	1,456,151		
1982	(1,671,301)	1,671,301	
Total federal tax refund			$737,402

* Investment tax credits carryback.

Bank A
Statement of Condition
1982

EXHIBIT II

	Before Tax Loss Carryback	Tax Refunds	Balance
Cash and cash in banks	$ 3,023,611	$821,440	$ 3,845,051
Investment securities	5,717,670		5,717,670
Loans	24,000,117		24,000,117
Property and equipment	878,958		878,958
Other assets	669,644		669,644
	34,290,000		35,111,440
Deposits	32,683,735		32,683,735
Other liabilities	368,975		368,975
Capital	250,000		250,000
Surplus	250,000		250,000
Undivided profits	737,290	821,440	1,558,730
	$34,290,000		$34,111,440
Capital to assets ratio	3.608%		5.863%
Taxable Loss	$(1,671,301)		

Bank B
Actual Tax Refunds From the 10-Year Net Operating Loss Carryback

EXHIBIT III

	Federal Taxable Income	Federal NOL Carryback	Tax Refunds Federal
1967	N/A		
1968	$ 41,234		$ 26
1969	56,629		1,331
1970	141,264	$ (141,264)	61,203
1971	174,029	(174,029)	76,967
1972	146,365	(146,365)	61,625
1973	187,685	(187,685)	83,283
1974	169,161	(169,161)	73,981
1975	101,027	(101,027)	31,473
1976	118,432	(118,432)	42,262
1977	204,809	(204,809)	78,846
1978	190,705	(190,705)	73,169
1979	316,935	(316,935)	118,133
1980	(3,219,557)	1,750,412 (1)	
		1,469,145 (2)	
Total federal tax refund			$702,299

(1) Used
(2) Carryover to 1985

Bank B
Statement of Condition
1980

EXHIBIT IV

	Before Tax Loss Carryback	Tax Refunds	Balance
Cash and cash in banks	$ 4,773,050	$807,389	$ 5,580,439
Investment securities	5,712,384		5,712,384
Loans	16,001,206		16,001,206
Property and equipment	217,522		217,522
Other assets	1,013,649		1,013,649
	27,717,811		28,525,200
Deopsits	26,953,317		26,953,317
Other liabilities	349,676		349,676
Capital	500,000		500,000
Surplus	1,000,000		1,000,000
Undivided profits	(1,085,182)	807,389	(277,793)
	$27,717,811		$28,525,200
Capital to assets ratio	1.496%		4.28%
Taxable Loss	$(3,219,557)		

EXHIBIT V

	Actual Loss	Average Loans Outstanding	Percentage of Loss	Total Assets
1975	$ 10,379	$2,798,228	.37%	$ 7,373,603.34
1976	10,350	3,067,315	.34%	8,009,212.12
1977	12,860	4,186,139	.31%	8,586,167.57
1978	12,346	4,804,659	.26%	9,504,806.78
1979	14,127	5,191,335	.27%	10,952,375.07
1980	48,879	5,276,445	.93%	11,330,366.35
1981	89,073	5,187,471	1.72%	13,265,532.12
1982	68,344	5,226,804	1.31%	14,482,364.32
1983	51,865	6,774,189	.77%	19,386,462.30
1984	158,694	7,373,582	2.15%	17,877,547.63
1985	161,698	6,881,833	2.35%	19,310,667.31

The Chairman. Thank you, Mr. Backlund.

Senator Dixon. Mr. Chairman, if I might interrupt for a moment, I have to go to the Armed Services Committee because we have Secretary Weinberger there, but Mr. Backlund touched on one point I wondered if someone on the panel here might address for me.

I'm finding a lot of opposition in my State to these limits on 401(k)'s and I wonder whether the Ways and Means Committee at least or somebody has suggested what the savings are. It can't be that significant in revenue savings. I'm curious as to what they contend the revenue savings is on limiting 401(k)'s. Does anybody know that?

The Chairman. I am not aware of that figure.

Senator Dixon. Or do they contend there's any revenue consequence? And if not, why do they do it?

The Chairman. You see, we have no idea why the House does anything.

Senator Dixon. I suspected as much, Mr. Chairman.

Mr. Backlund. I would be interested too, Senator.

Senator Dixon. It's nothing but a lowly plot by the other House then?

The Chairman. We will find out.

Mr. Macy.

STATEMENT OF J. THOMAS MACY, AUDIT PARTNER, PRICE WATERHOUSE, NEW YORK, NY; REPRESENTING THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Chairman Garn, members of the Committee, my name is J. Thomas Macy. I am a Price Waterhouse partner with 25 years of experience auditing bank operations and bank financial statements. I currently serve as Chairman of the Banking Committee of the American Institute of Certified Public Accountants and am appearing before you today on behalf of the Institute.

Specifically, I am here to discuss our concerns with the House tax bill, particularly as it affects commercial banks. The bill as written will have an adverse impact on banks, both domestically and in their international operations. It seems likely that the foreign tax changes will limit the ability of U.S. banks to compete in the international market place, but I plan to focus my remarks solely on the loan loss reserve issue.

The House bill repeals, for tax purposes, the reserve method of accounting for bad debts of large commercial banks and requires the payment of tax on reserves deducted in previous years. For those banks, a deduction will be allowed only when a specific loan is charged off. On the other hand, the bill continues to provide tax recognition of the loan loss reserve for banks whose assets do not exceed $500 million. In so doing, the House bill properly sustains, at least in part, the long-standing principle of deductibility of bank loan loss reserve additions. That principle, however, should apply with equal force to all banks, regardless of size. In fact, I am strongly recommending that the tax reserve should be the same as the book reserve -- an approach embodied in a bill introduced last year by Senator Roth and Senator Boren.

Repeal of the loan loss reserve deduction is the single most far-reaching bank tax change made by the bill. It overturns 65 years of tax recognition of one of the more significant costs of carrying on the banking business -- the maintenance of adequate loan loss reserves. Repeal will put the Federal tax authorities in direct conflict with:

- generally accepted accounting principles,
- established banking industry practice,
- bank regulatory agencies,
- the Securities and Exchange Commission,
- bank financial analysts,
- bank shareholders,
- the marketplace, and
- the public at large.

But perhaps of greatest importance to this Committee, it may well have a negative impact on the safety and soundness of the banking system, as measured by bank capital.

In recommending book/tax conformity with respect to the loan loss reserve issue, I should like to make the following points:

- First, the reserve method of accounting for loan losses is required by virtually all users of bank financial statements.
- Second, the reserve method results in the proper measurement of economic income. Current loan losses are recognized currently, not deferred to the future.
- Third, the reserve method has 65 years of historical precedents in income tax rulings and legislation.
- Fourth, the reserve method is not a "tax shelter". In fact, in recent years it has acted as a "reverse tax shelter".
- Fifth, the reserve method is an important factor in maintaining the safety and soundness of the banking system.

Financial Statements

The reserve method of accounting for loan losses is required by virtually all users of bank financial statements.

To present fairly financial statements of commercial banking organizations, accountants require the reserve method of accounting for loan losses. Such accounting is required under generally accepted accounting principles as set forth in authoritative accounting pronouncements. According to the AICPA Bank Audit Guide, "The amount of the provision can be considered reasonable when the allowance for loan losses, including the current provision, is considered by management to be adequate to cover estimated losses inherent in the loan portfolio." (Emphasis added.) The accounting profession is not alone in requiring the reserve method.

Bank holding companies file reports with the Securities and Exchange Commission and are required to use generally accepted accounting principles. Under Regulation S-X, Article 9, the SEC requires the reserve method of accounting for loan losses.

The Federal bank regulatory agencies require the reserve method of accounting for loan losses. These requirements are found in the Instructions for the Preparation of Reports of Condition and Income ("Call Reports") prescribed by the Federal Financial Institutions Examination Council.

Security analysts and credit analysts focus on the reserve for loan losses when analyzing banks. These analysts consider reserve adequacy to be a key factor in evaluating the quality of bank earnings.

The public at large expects that banks will maintain adequate loan loss reserves. This expectation is reflected in the market place for bank stocks and in press commentaries on the quality of bank earnings. To the extent there are current concerns, they relate to the possible understatement of loan loss reserves, not to the overstatement of such reserves.

In summary, virtually all users of bank financial statements believe the reserve method of accounting for loan losses is appropriate, indeed essential. They are concerned as to the adequacy of these reserves.

Income Measurement

The reserve method results in the proper measurement of economic income. Current loan losses are recognized currently, not deferred to the future.

The proposed repeal of the loan loss reserve deduction for banks with assets in excess of $500 million is based primarily on the premise that the losses "statistically occur in the future". That premise is false; it conflicts with the economic reality of when losses do in fact occur.

When evaluating the collectibility of a loan portfolio, bankers know from past experience that some loans are bad. At any given moment in time, however, it is not possible to identify all of the specific loans which will not be repaid. Those that can be identified are charged off immediately. For the remainder, the charge-off may not be recorded until long after the actual economic loss has occurred.

The economic event, for example, that has triggered current losses in bank energy portfolios occurred when oil prices tumbled recently. The losses have already occurred. They exist right now. The problem is solely one of identification of which specific loans in the energy portfolio have been adversely impacted by this oil price decline. These losses are part of the current, not future, costs of the business. Therefore, to reflect in the income statement the economic reality of these current but unidentified losses inherent in the loan portfolio, bankers establish a reserve.

When I sit down with clients to review the adequacy of their reserves, as I have been doing on a quarterly basis for years, we look at a number of things. We look at individual loans, loan concentrations, aggregate amounts of troubled loans, nonperforming loans, loans adversely classified by bank regulatory examiners, and trends in charge-offs. We also consider macroeconomic factors, both domestic and international. The AICPA Banking Committee, which I chair, currently has under development an auditing procedures study on auditing the reserve for loan losses to help improve this process.

Loan losses are a normal recurring expense of being in the lending business -- much as depreciation of equipment is an essential element in determining the income of a manufacturing business. The reserve method of accounting for loan losses rests upon a key principle of accounting, which is to match current income with current expense. Under this concept, it is appropriate -- indeed, absolutely essential -- to recognize a provision for loan losses at the same time as the related income is being recognized. This matching of income and expense results in a fair presentation of operating results. If the reserve method of accounting for current losses in the loan portfolio is not used in the determination of taxable income, then taxable income will be overstated in years prior to the actual charge-off, resulting in the prepayment of taxes relative to the recognition of economic income.

By way of analogy, a reserve for depreciation is employed in properly accounting for the use of equipment to produce income in a manufacturing business. To satisfy the accounting principle of matching income and expense, businesses establish a depreciation reserve, recognizing depreciation in their income statements as an expense of doing business. This approach better matches the overall recognition of operating income with the expenses incurred to produce such income. In other words, it is appropriate to recognize the expense of a depreciation reserve, as well as a loan loss reserve, at the same time as the related income is being recognized.

Historical Income Tax Treatment of Bank Bad Debt Reserves

The reserve method has 65 years of historical precedents in income tax rulings and legislation.

Federal income tax laws and rulings have historically recognized the appropriateness of allowing a deduction for bad debt reserves for both financial institutions and nonfinancial institutions. Banks have been allowed to establish reserves for bad debts for Federal income tax purposes since 1921. The reserve method has been reaffirmed repeatedly by the Internal Revenue Service and in tax legislation over the past 65 years.

Statutory recognition of bank loan loss reserve deductions has been provided since 1969. Congress has reconsidered these provisions in a number of major tax bills in recent years, but repeal of the deduction has never been proposed until the present.

The House bill continues the principle of the reserve method of accounting for loan losses. Unfortunately, however, the bill introduces an insupportable discriminatory element by not applying this 65 year-old principle to banks whose assets exceed $500 million.

The principle of determining taxable income for banks by using the reserve method for loan losses should be continued for all banks regardless of size, location, or any other attribute.

Not A Tax Loophole

The reserve method is not a "tax shelter". In fact, in recent years it has acted as a "reverse tax shelter".

Let me address the charge, repeated in recent press accounts, that the loan loss reserve is banking's favorite "tax shelter".

It should be recognized that the current tax law with respect to loan loss reserves does not provide any tax incentives. In recent years, and let me emphasize this, bank loan loss reserves have not resulted in reducing the effective current Federal income tax rate for banks. Indeed, for many banks the opposite has resulted since banks are presently limited to a deduction that equals a reserve amounting to only .6% of eligible loans. Many banks currently report higher reserves in their financial statements, not because of any income tax benefits, but rather because of legitimate concerns regarding the collectibility of their loan portfolios in the current economic climate. For example, at December 31, 1985, the 15 largest U.S. bank holding companies had an average ratio of their reserve for loan losses to total loans of 1.62%. This compares with 1.33% at December 31, 1984.

Why then, you may ask, do banks need a tax deduction for loan loss reserve additions? The answer, from a bank safety and soundness perspective, is that the inability to currently deduct additions to loan loss reserves results in the prepayment of income taxes by banks. That is, banks are paying taxes on economic income before they are recognizing that income. Until recently, banks were able to offset these tax prepayments with tax deferrals arising from other tax items. For example, banks as well other businesses have been able to defer tax through the use of accelerated depreciation. However, we are rapidly approaching the point at which prepayments of tax arising from the nondeductibility of loan loss reserve additions will exceed such tax deferrals.

When this occurs, these tax prepayments may have to be charged as a reduction of earnings and, therefore, as a reduction of bank capital. This charge to capital is mandated under certain circumstances by recently issued regulations of the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation. The Financial Accounting Standards Board is currently considering the issue of accounting for net tax prepayments.

For many banks the year of crossover from net tax deferral to net tax prepayment may be this year, 1986. Thus, a concern that has been bubbling below the surface may soon erupt into a more serious problem. This problem will be significantly exacerbated by the House bill's repeal of the loan loss reserve deduction for banks with assets in excess of $500 million.

Bank Safety and Soundness

The reserve method is an important factor in maintaining the safety and soundness of the banking system.

Bank safety and soundness is an important concern for all banks, whether large or small. It is of equal concern, moreover, for the bank regulators.

In assessing the safety and soundness of a bank, a key measurement is the level of a bank's capital, including the reserve for loan losses. Enactment of the House bill's repeal of the deduction for loan loss reserves for all but the smallest banks may result in a reduction of bank capital for two reasons:

- One, as I just explained, net tax prepayments may have to be charged to capital. These prepayments will increase significantly when previously deducted loan loss reserves are reversed back into taxable income, as required by the House bill.
- Two, the nondeductibility of loan loss reserves will significantly increase the cost of adding to these reserves, thus creating a real economic disincentive to such additions.

It's not just the bankers and accountants who are concerned about this problem. This past November, Mr. L. William Seidman, newly appointed Chairman of the Federal Deposit Insurance Corporation, addressed over 570 CPAs, bankers, and bank regulators at a banking conference sponsored by the AICPA here in Washington. He said that he had recently told Treasury Secretary Baker that some of his people may need "a little better guidance in the banking area", because "here we were, working very hard to increase reserves for the soundness and stability of the system, and there they were, working very hard to take away the deduction." "In a word," concluded Chairman Seidman, "I think the Administration is on the wrong side of that issue."

Recommendation

I would like to close with a strong recommendation for the continued recognition of loan loss reserves for tax purposes for all banks, regardless of size. In fact, I recommend enactment of the principles contained in the bill introduced last year by Senator Roth and Senator Boren (and initially approved by the House Ways and Means Committee as part of the House bill). These principles require conformity between the loan loss reserve maintained by banks for tax purposes and the reserve maintained for financial statement purposes.

The adoption of a book/tax conformity requirement would provide a more rational system for determining the bad debt deduction for banks than either the House bill or present law. Such a rule clearly would be more consistent with a fundamental tenet of the income tax system and one of the President's stated goals of tax reform -- fairness.

Furthermore, focusing on current losses inherent in the loan portfolio makes more sense than what is referred to as the "experience method" contained in present law. The correct approach is to assess current losses in the portfolio. The most rational, reasonable, and least arbitrary means of accomplishing this goal is to employ the widely accepted loan loss reserve method.

In summary, we believe that book/tax conformity for loan loss reserves is the right answer, because the reserve method of accounting for loan losses --

- is required by virtually all users of bank financial statements,
- results in the proper measurement of economic income by recognizing loan losses currently,
- has 65 years of history behind it,
- is not a tax shelter, and
- is an important factor in maintaining the safety and soundness of the banking system.

The CHAIRMAN. Thank you, Mr. Macy.

Mr. Shipley.

STATEMENT OF WALTER V. SHIPLEY, CHAIRMAN OF THE BOARD AND CEO, CHEMICAL NEW YORK CORP., NEW YORK, NY; REPRESENTING THE NEW YORK CLEARING HOUSE ASSOCIATION, ACCOMPANIED BY ROBERT J. QUINLAN, SENIOR VICE PRESIDENT AND DIRECTOR OF TAXES FOR CHEMICAL BANK AND CHAIRMAN OF THE TAXATION COMMITTEE, THE NEW YORK CLEARING HOUSE ASSOCIATION

Mr. SHIPLEY. Good morning, Mr. Chairman and Senators D'Amato and Hecht. My name is Walter Shipley. I am chairman and chief executive officer of Chemical New York Corp. at Chemical Bank, but I appear before you this morning as chairman of the Clearing House committee of the New York Clearing House Association. I am accompanied by Robert J. Quinlan, senior vice president and director of taxes for Chemical Bank and chairman of the taxation committee of the New York Clearing House Association. The New York Clearing House Association is comprised of 12 commercial bank members, 6 of which are among the 10 largest banking institutions in the United States, measured by assets.

The New York Clearing House is a strong supporter of tax reform when the effect is to achieve increased fairness, equity, and simplicity in our Federal tax laws and indeed H.R. 3838 does contain certain provisions such as the reduction in tax rates and the elimination of numerous tax brackets, which meet these worthy goals. However, H.R. 3838 also contains certain provisions that do not promote fairness, equity, or simplicity, and in fact have quite the opposite impact on the banking industry. I would like to devote my limited time this morning to just two of these provisions: The provisions impacting the loan loss reserve and the foreign tax credit areas.

ADVERSE EFFECTS OF THE TWO PROVISIONS

These two provisions were selected by the New York Clearing House because they have a major adverse effect on the ability of the U.S. banking industry to conduct business in our traditional marketplaces. Furthermore, we do not believe that either provision can be justified as true tax reform in the sense of adding to the fairness, equity, and simplicity of the Federal tax laws.

As to the elimination of the reserve method of accounting for loan loss and the requirement that banks restore existing loan losses to taxable income over a 5-year period, you have already heard excellent discussions of these provisions by Don Senterfitt and Tom Macy. Let me briefly and clearly emphasize that the New York Clearing House joins them in strong support of Senate bill 1263, cosponsored by Senators Roth and Boren, which would permit banks a loan-loss reserve for tax purposes equal to the reserves reflected for financial accounting purposes. By permitting such conformity S. 1263 would make Federal laws consistent with the goals of the regulators—that being the Fed, the Comptroller of the Currency, the FDIC, and the SEC—all of whom have been advocating increases in banking industry loan-loss reserves in order to enhance the safety and soundness of the banking system and the individual capital position of each banking institution. By eliminating the loan-loss reserve method, H.R. 3838 would greatly diminish the incentives to build the capital positions of banking institutions and would cause an improper matching of the income from a loan portfolio with the losses that are inherent in that loan portfolio.

The New York Clearing House also objects to the provision in H.R. 3838 which would arbitrarily deny the right to utilize the reserve method of accounting for loan losses when a bank's assets exceed $500 million. It won't surprise you to learn that that was the unanimous view of the Clearing House Association. This provision, in our judgment, reflects neither logic nor sound tax policy. The need for safety and soundness and an adequate capital position does not diminish as a bank becomes larger.

The New York Clearing House is especially well qualified to discuss the second set of provisions objected to by our members, the foreign tax credit provisions. Our combined membership is responsible for providing financing for a sizable portion of total U.S. exports. As a result, our members are responsible for a significant positive influence on the U.S. balance of trade and for increased U.S. employment in both the U.S. exporting company and the member bank providing the export financing. We are sincerely alarmed by the H.R. 3838 provisions which would decrease the ability of U.S. banks to take a credit on their U.S. tax returns for withholding taxes imposed by foreign countries an interest income earned in those countries.

As a result of this decreased availability of foreign tax credits, U.S. taxes on total foreign income on U.S. banks would increase. U.S. banks would therefore have to charge a higher rate of interest in order to earn the same yield as their foreign bank competitors. However, in many cases U.S. banks are unable to charge a higher rate of interest—in fact, in most cases. They are already locked in fierce international competition with foreign banks whose home country's tax laws, capital requirements, loan loss treatment and treaty networks already give them a competitive advantage over U.S. banks.

HINDRANCE TO FINANCING OF U.S. EXPORTS

The proposed provisions exacerbate this existing competitive disadvantage and as a result U.S. banks would be further hindered in certain foreign marketplaces resulting in less financing of U.S. exports into those markets. The consequences would be decreased U.S. exports, a further worsening of the U.S. balance of payments and a decline in U.S. employment.

Some have implied that the current U.S. tax laws have resulted in a preference by U.S. banks for loans that attract a high rate of foreign withholding tax. Such is not the case. In fact, the New York Clearing House would urge Treasury to utilize its best efforts in treaty negotiations to reduce foreign withholding taxes imposed on interest income and is prepared to actively support such efforts. U.S. banks lend into a foreign marketplace on the basis of business considerations and not on the basis of tax considerations.

These adverse foreign tax changes come at a time when Treasury Secretary Baker is urging us to supply some $20 billion of new funds to less-developed countries. The foreign tax provisions of H.R. 3838 specifically create disincentives to such lending on the part of U.S. banks at a time when the administration is strongly encouraging support from governments and financial institutions around the world.

We would respectfully urge this committee to support retention of the current rules governing foreign withholding taxes. H.R. 3838 would permit most nonbanks to continue to utilize current law in the calculation of foreign tax credits. We are merely requesting that we be similarly allowed to utilize current tax law in this area.

I would like to use my remaining time to address very briefly the major issues relating to the erroneous perception held by some that banks do not pay their fair share of taxes. I bring this up now because it appears that a major thrust of these tax reform proposals as they relate to banks is based on this incorrect premise.

This perception is often based on so-called effective tax rate studies such as the study sponsored annually by Congressmen Pease and Dorgan and prepared by the Joint Committee on Taxation. Such studies attempt to measure only Federal income taxes paid and ignore the sizable amounts of other taxes paid by banking institutions such as State and local income, franchise and business privileges taxes, real estate taxes, payroll taxes, sales and use taxes, and foreign taxes.

INTEREST FOREGONE ON BANK RESERVES

The Pease-Dorgan study and most other effective tax rate studies also ignore two very large indirect taxes which are borne by the banking industry. The first indirect tax is represented by the interest foregone on the reserves that banks are required to maintain with the Federal Reserve System. The Federal Reserve, in turn, earns market rates of interest on those reserve deposits and, after payment of relatively minor amounts of expenses, turns over the proceeds to the U.S. Treasury just as any other form of Federal tax is paid to the Treasury. In this case, the check in payment of the Federal income tax is written by the Federal Reserve System, but the burden of the tax is borne by the banking industry.

In the case of my own institution, during 1985, Chemical Bank maintained average reserve balances with the Federal Reserve System of $475 million. When the Federal Reserve's average rate of return on all assets of 8 percent is applied to these reserves, this results in an implicit tax imposed on Chemical New York Corp. of $39 million.

Speaking for Chemical, we would be quite happy to receive interest on those reserves and pay Federal income taxes on such income.

INTEREST FOREGONE ON TAX-EXEMPT OBLIGATIONS

The second implicit tax borne by the banking industry is represented by the interest foregone by banks on tax-exempt obligations. Congress has made a public policy decision to subsidize borrowings by State and local governments and banks have traditionally been significant dealers in municipal securities. The interest foregone by banks on tax-exempt obligations, representing the difference between a taxable yield and a tax-exempt yield, is an implicit tax on banks and other holders of such obligations. A Federal Reserve study has noted that this foregone interest is a tax which is paid to the issuers of the municipal bond and which is properly added to the other taxes in computing the burden of taxation.

Again in the case of Chemical New York Corp., this second implicit tax amounted to $232 million for 1985. Adding these two implicit taxes to Chemical's current 1985 taxes payable results in a 1985 effective tax rate for Chemical Bank of 46.5 percent.

The Bank Administration Institute has conducted surveys of the effective tax burdens of all U.S. commercial banks. They demonstrated that when these two implicit taxes were added to the effective tax rates calculated under the methodology employed in the Pease-Dorgan study, the effective tax rate of U.S. commercial banks was at or above the maximum statutory rate of 46 percent.

Thank you again, for the opportunity to represent the views of the Clearing House. While the Clearing House members are supportive of the principal objective of tax reform, we strongly urge that Congress understand clearly the economic implications and the effect on bank soundness and safety resulting from the two issues I have addressed today, particularly in the context of the misperception that banks do not pay their fair share of taxes.

Hopefully, if you share these concerns they will be communicated to the Senate Finance Committee and other members of the Senate. I hope our comments have been helpful and we'd be happy to answer any questions you have.

[The complete prepared statement follows:]

Statement of Walter V. Shipley
on Behalf of
The New York Clearing House Association

Mr. Chairman and members of the Committee, my name is Walter V. Shipley. I am Chairman of the Board and Chief Executive Officer of Chemical New York Corporation and Chairman of the Clearing House Committee of The New York Clearing House Association. I am accompanied today by Robert J. Quinlan, Senior Vice President and Director of Taxes for Chemical Bank and Chairman of the Taxation Committee of The New York Clearing House Association. The New York Clearing House Association is comprised of twelve commercial bank members,* six of which are among the ten largest banking institutions in the United States measured by assets.

I appreciate the opportunity to appear before this Committee to discuss the impact on the banking industry of H.R. 3838, the "Tax Reform Act of 1985," as passed by the House of Representatives last December.

The New York Clearing House is a strong supporter of tax reform if the intent is to promote increased fairness, equity and simplicity in our federal tax laws. And indeed H.R. 3838 contains certain provisions, such as the reduction in tax rates and the elimination of numerous tax brackets, which meet these worthy goals. However, H.R. 3838 also contains certain provisions that do not promote fairness, equity or simplicity, and in fact have quite the opposite impact on the banking industry. I would like to devote my limited time this morning to just two of these provisions:

- The provision denying to larger banks tax deductions for loan loss reserves which banks are required to maintain for bank regulatory and financial accounting purposes.
- Certain foreign provisions which apply exclusively to financial institutions.

These two provisions were selected by The New York Clearing House because they have a major adverse impact on the health of the U.S. economy and on the ability of the U.S. banking industry to conduct business in our traditional marketplaces. Furthermore, we do not believe that either provision can be justified as true tax reform in the sense of adding to the fairness, equity and simplicity of the federal tax laws. Because these two provisions would adversely affect the U.S. economy and the competitiveness of the U.S. banking industry, I would urge the members of this Committee to communicate our concerns in these two areas to the members of the Senate Finance Committee.

I would also like to devote some of my time to the misperception held by some members of Congress and certain media representatives that commercial banks do not pay a fair share of taxes under present law. These misperceptions ignore the very substantial indirect taxes that are paid by banks in the form of foregone interest on reserve deposits and reduced yields on state and local government obligations. I would also urge the members of this Committee to communicate our concerns about these misperceptions to the members of the Senate Finance Committee.

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* The members are The Bank of New York, Chase Manhattan Bank, N.A., Citibank, N.A., Chemical Bank, Morgan Guaranty Trust Company of New York, Manufacturers Hanover Trust Company, Irving Trust Company, Bankers Trust Company, Marine Midland Bank, N.A., United States Trust Company of New York, National Westminster Bank USA, and European American Bank.

I. Denial to Larger Banks of Tax Deductions for Reasonable Bad Debt Reserves

The House-passed bill would deny to commercial banks with assets of $500 million or more deductions for reasonable additions to a reserve for bad debts, and would allow deductions for bad debts only when the debts are charged off. It would also require reserves previously deducted to be brought back into income.*

A. Summary of the Clearing House Position

The New York Clearing House strongly supports Senate Bill 1263, co-sponsored by Senators Roth and Boren, which would permit banks a loan loss reserve for tax purposes equal to the reserve reflected for financial accounting purposes. By permitting such conformity, S. 1263 would make federal tax laws consistent with the goals of the banking regulators (the Federal Reserve System, the Controller of the Currency, the Federal Deposit Insurance Corporation and the Securities and Exchange Commission) all of which have been advocating increases in banking industry loan loss reserves in order to enhance the safety and soundness of the banking system and the individual capital position of each banking institution. By eliminating the loan loss reserve method, H.R. 3838 would impair the capital positions of banking institutions and would cause an improper matching of the income from a loan portfolio with the losses that are inherent in that loan portfolio.

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* H.R. 3838, 99th Cong., 1st Sess. § 801 (1985).

The New York Clearing House also objects to the provision in H.R. 3838 which would arbitrarily deny the right to utilize the reserve method of accounting for loan losses when a bank's assets exceed $500 million. This provision reflects neither logic nor sound tax policy. The need for safety and soundness and an adequate capital position does not diminish as a bank becomes larger.

B. House Ways and Means Committee's Reasons for Change

The House Ways and Means Committee's Report purports to justify the House bill's proposal by making contradictory statements. It first states that the Committee "generally" believes that the reserve method of accounting for bad debts should be repealed for several reasons. It then states that the Committee is concerned that repeal for smaller banks may have "some potential adverse impact," and that continued availability of reserves for those banks, as under present law, is justified. Finally it states that the Committee bill retains present law regarding the use of reserves "except in the case of 'large banks'."* The Report ignores the plain fact that the reasons for retaining the reserve method logically apply to all banks.

The House Report also states that the reserve method should be repealed because it "results in deductions being taken for tax purposes for losses that statistically occur in the future."** As the following discussion shows, a bad debt reserve is not a reserve for future losses, but for present losses inherent in a loan portfolio at a given time. At any time the loans in a portfolio are in various categories of collectibility. Some borrowers will have not been paying interest on their loans for a long time. Some borrowers will be on the verge of bankruptcy. In the vast majority of cases, a loan loss does not happen all at once; it is a degenerative process. Because bad debts ordinarily cannot be identified until after collection attempts have been made, banks must estimate the portion of loans in the portfolio that is currently bad and establish a reserve.

Finally, the House Report suggests that the deduction for a reasonable addition to a reserve for bad debts is inconsistent with the treatment of other deductions under the Internal Revenue Code.* In fact, it is consistent with and parallel to deductions for depreciation and for decreases in the value of inventories. If a manufacturer buys a machine and puts it on a production line for its useful life, after which it is sold at a loss, no one would suggest that the manufacturer should not be allowed depreciation deductions until the machine is sold. But this is precisely what would follow from the "charge off" approach proposed by the House bill, because the amount of the actual loss is not determined until the machine is disposed of. Similarly, deductions for decreases in the value of inventories are recognized where the decreases occur and are not deferred until the inventories are sold. In both cases, just as in the case of loan losses, there is a front-end expenditure, and there is or may be a degradation in worth which is currently recognized for both tax and financial accounting purposes. These are not future losses, but are inherent in an asset as of the end of an accounting period and should be reflected in the income of the period in order to properly measure that income.

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* H.R. Rep. No. 426, 99th Cong., 1st Sess. 577 (1985).

** Id.

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* See H.R. Rep. No. 426, 99th Cong., 1st Sess. 577 (1985).

C. The Reserve Method of Accounting for Bad Debts More Clearly Reflects Income.

Since 1921, all businesses have been allowed to deduct a reasonable addition to a reserve for bad debts. When a non-financial business makes sales that are reflected in accounts receivable, and reports the sales as taxable income, some of these receivables will statistically become bad debts. According to the principles of accrual basis accounting, the cost of the bad debts is allocable to, and properly deductible against, the sales which generated additional receivables, in order to properly reflect the income from the sales. In the case of financial institutions, which sustain bad debts in the course of an ongoing lending business, bad debt losses (principal losses) are properly matched against the interest which accrues each year in the course of the institution's lending business.

The proper matching of items of income with the deductions incurred to produce the income is one of the major objectives of a fair and neutral tax system. The House bill's proposal to postpone a bad debt loss deduction until the taxable year in which an individual debt becomes either wholly or partially "worthless"[*] would distort bank income by improperly matching income and expense, because interest will have accrued and been taxed in earlier taxable years even though a portion of it may never be collected.[*]

The reason that the reserve method of accounting for bad debts has survived through successive Congresses and Administrations, despite modifications to the formula for computing a "reasonable addition," is the method's consistency with the accrual method of accounting. The House bill's proposal to permit bad debt deductions to larger banks only when individual debts become "worthless" is inconsistent with accrual accounting, under which expenses are recognized at the same time related income is recognized rather than when an actual cash loss occurs.

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[*] The House Ways and Means Committee's Report states that worthlessness is a question of fact, to be determined by considering all pertinent evidence, including all of

(Footnote Continued)

(Footnote Continued)

the facts and circumstances, the financial condition of the debtor and the value of collateral. H.R. Rep. No. 426, 99th Cong., 1st Sess. 576 (1985). Mandatory use of this standard would generate much uncertainty and litigation. In addition, the practical effect would likely be that deductions for loan losses would be allowed only when the loan is actually charged off, which would distort the taxpayer's income in the case of loans that become worthless over a period of more than one taxable year.

[*] Many large deficiencies have been proposed or assessed on audits by the Internal Revenue Service against banks which did not accrue and include in their gross income interest on loans identified as "non-performing" or "non-accrual" for financial accounting purposes.

D. The Internal Revenue Code Provisions For Commercial Bank Bad Debts Should Conform to the Reserves That Are Required For Financial Accounting and Bank Regulatory Purposes.

The availability to financial institutions under present law of the percentage and modified experience methods of computing a reasonable addition to a bad debt reserve depends upon a taxpayer's status as a bank subject by law to non-tax regulation.[*] The incorporation of or reference to non-tax law by the Internal Revenue Code reflects the economics of different businesses, and, in addition, prevents taxpayers from entering into purely tax-motivated transactions.[*] For example, the Internal Revenue Code contains special rules for life and non-life insurance companies, natural resource companies, investment companies and other special classes of taxpayers, which would be retained under the Treasury's fair and neutral tax system.

Further, the supervision by the bank regulatory authorities of commercial banks assures that reserve accounting for banks will bear a strong relationship to expected losses. This was noted by the Staff of the Joint Committee on Taxation in its review of banks and thrift institutions, prepared for the use of the Senate Committee on Finance in March 1983, when it concluded that the additions to the loan loss reserves for financial accounting purposes have recently often been greater than amounts allowed for tax purposes.[*] As a result, taxable income has been greater than income for financial reporting purposes, which is hardly the hallmark of a tax expenditure.[**]

Since the 1983 hearing, it has become abundantly clear that reserves for bad debts are not overstated in the case of commercial banks, contrary to the undocumented statements in the House Report on H.R. 3838.[***] Bank regulatory authorities are currently very concerned with increasing the size of the bad debt reserves of banking institutions in light of recent widely publicized bank failures and near-failures due to loans, such as farm loans and energy loans, the repayment of which is greatly influenced by economic conditions. Those failures and near-failures have affected larger as well as smaller banks, which demonstrates that there is no validity in practical experience to the distinction made in that regard in the House bill. The House bill's

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[*] *See* Section 581 of the Internal Revenue Code.

[**] *Cf.* Rev. Rul. 84-94, 1984-1 C.B. 34 (bank loan to a foreign debtor will be presumed worthless for federal income tax purposes if subject to an "allocated transfer risk reserve" under non-tax regulations directed by the International Lending Supervision Act of 1983).

[*] *See* Staff of the Joint Committee on Taxation, *Taxation of Banks and Thrift Institutions* 21 (March 19, 1983).

[**] Table 1 of the Joint Committee on Taxation's pamphlet entitled "Tax Reform Proposals: Taxation of Financial Institutions" (JCS-38-85) (September 12, 1985) gives such an example on pp. 16-17.

[***] *See* H.R. Rep. No. 426, 99th Cong., 1st Sess. 577 (1985).

proposal would undercut these and other efforts to increase the reserves and capital of banks.

The House bill would make tax policy and accounting diverge from, rather than conform more closely to, sound bank regulatory and financial accounting principles. It would also be unsound as a matter of tax policy because it would mismatch interest income and bad debt expense during periods after default and prior to charge off when collection is sought.

II. Adverse Foreign Provisions

Two foreign provisions of the House bill are specifically adverse to commercial banks:

(1) Imposition of a separate limitation on the credit for foreign gross withholding taxes, as an exception to the "overall" method of calculating the limitation for most other kinds of foreign taxes; and

(2) Current taxation of banking income earned by foreign subsidiaries of U.S. banks, while continuing to defer the taxation of most other types of active business income of foreign subsidiaries of other U.S. corporations.

A. Creditability of Foreign Gross Withholding Taxes

The purpose of any foreign tax credit limitation is to prevent taxpayers from using foreign tax credits to reduce U.S. tax liability on domestic income. Under the overall limitation, the amount of foreign tax credits which

a taxpayer can apply against its U.S. tax liability on its worldwide income is limited to the product of (1) its U.S. tax liability (before credits) and (2) a fraction, the numerator of which is the taxpayer's non-U.S. source taxable income and the denominator of which is the taxpayer's worldwide taxable income. In determining the fraction's numerator under the overall limitation, current law permits the taxpayer to aggregate all of its items of income, loss, deduction and credit from foreign sources. The House bill would deny a credit for foreign gross withholding taxes to banks and other financial institutions to the extent that such taxes exceed the U.S. tax on the associated net interest income. This limitation on gross withholding taxes would apparently be determined on a loan-by-loan basis.

1. Summary of the Clearing House Position

The proposal to impose a special limitation on gross withholding taxes of financial institutions is inconsistent with the objectives of fairness, simplicity and economic growth. The proposal does not increase fairness because it applies only to financial institutions. The proposal would substantially increase, rather than decrease, the complexity of The Internal Revenue Code, without any expectation that corresponding gains in efficiency and equity would occur. Finally, adoption of the limitation would discourage or penalize loans by U.S. financial institutions to countries with gross withholding taxes, and contradict the Administration's announced policy of encouraging loans to developing countries, which ordinarily impose such taxes. It would also contradict the policy of encouraging loans to finance exports to countries which impose such taxes.

2. The House Ways and Means Committee's Reasons for Change

The House Ways and Means Committee Report on H.R. 3838 suggests in its discussion of the rationale for this provision that the overall method as applied to gross withholding taxes, provides an "incentive" for U.S. lenders to make loans to foreign rather than domestic borrowers, and to make "otherwise uneconomical" loans.* This is both illogical and erroneous. Market conditions determine whether loans will be made to foreign or domestic borrowers and the terms of the loans. Banks have no control over the taxes that may be imposed by foreign countries on loans to foreign borrowers, and those taxes may change after loans have been made. The overall limitation is neutral with respect to those taxes; they are creditable so long as in the aggregate they do not exceed the U.S. tax that would otherwise be imposed on all foreign income. Because taxes in excess of that limitation are not creditable, and therefore can never reduce U.S. tax on domestic source income, U.S. lenders do

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* *See* H.R. Rep. No. 426, 99th Cong., 1st Sess. 350 (1985).

not benefit from high foreign withholding taxes of any kind, and there is therefore no "incentive" or make loans to foreign rather than domestic borrowers, or to make "uneconomic" loans. The New York Clearing House and its member banks would urge the Treasury Department to negotiate reduced foreign withholding taxes through tax treaties.

3. Analysis

The New York Clearing House Association strongly disagrees with the undocumented assertion in the Report of the House Ways and Means Committee that the overall limitation provides an "incentive" to some U.S. lenders "to lend funds overseas rather than at home."* The special limitation in the House bill is likely to distort worldwide investment decisions to the detriment of the U.S. economy. Furthermore, the Clearing House believes that the House has seriously underestimated the complexity of the special limitation, and the impact of such complexity on administrative efficiency and taxpayer compliance.

a. The Special Limitation is Likely to Distort Worldwide Investment Decisions to the Detriment of the U.S. Economy.

The special limitation on foreign gross withholding taxes proposed by the House deviates from the ideal of economic neutrality (Section i below), discourages or penalizes loans to countrier which impose gross withholding taxes (Section ii), and undermines the Administration's policy of encouraging investment in developing countries (Section iii). As a result, the special limitation would distort international lending operations to the detriment of the U.S. balance of payments and domestic employment. (Section iv).

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* H.R. Rep. No. 426, 99th Cong., 1st Sess. 350 (1985).

i. The House Bill's Limitation Deviates from the Ideal of Economic Neutrality.

A foreign tax credit system is a unilateral method of eliminating international double taxation on the nationals of a country which imposes a tax on the worldwide income of its nationals. The objective of the U.S. foreign tax credit system is to avoid double taxation of foreign income, while the limitation on the credit is intended to prevent the credit from reducing the U.S. tax on domestic income. To avoid double taxation of foreign income, the U.S. foreign tax credit system is designed so that the country in which a business activity is conducted, or in which any income is earned, has the first right to tax the income arising from that country, while the U.S., as the home country of the individual or corporation, has a residual right to tax the income to the extent that it has not already been taxed. The limitation on the foreign tax credit preserves the right of the United States to tax income from domestic sources.

Although the logic of a foreign tax credit system does not dictate the form of the limitation, one method will be more appropriate than another depending on the attitudes of the crediting country toward foreign investment and taxpayer equity. In its statement of the goals of fundamental tax reform, the Treasury Department Report to the President cites economic neutrality as the first goal of an ideal tax system:

> [A]n ideal tax system would be as neutral as possible toward private decisions. Any deviation from this principle represents implicit endorsement of governmental intervention in the economy -- an insidious form of industrial policy based on the belief that those responsible for tax policy can judge better than the marketplace what consumers want, how goods and services should be produced, and how business should be organized and financed.*

In the context of international business transactions, the goal of economic neutrality would be achieved if every country measured the tax base in the same fashion, applied the same source rules and imposed the same tax rate. In such a world, worldwide investment decisions could be made without any consideration of taxes. Unfortunately, national tax systems differ, and economic neutrality is best approximated by a foreign tax credit system that results in foreign income being taxed at the same rate as domestic income, to the extent consistent with the right of the home country to tax domestic income.

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* 1 The Treasury Department Report to the President: Tax Reform for Fairness, Simplicity and Economic Growth 13 (1984).

An overall limitation approximates this goal of economic neutrality. Under the overall limitation, a taxpayer can approximate economic neutrality with respect to its own foreign investments or operations by deriving income both from countries with a higher rate of tax than the U.S. rate and from countries with a lower tax rate. The overall limitation effectively permits taxpayers to aggregate foreign tax rates, but it does not impair in any way the right of the United States to tax domestic income. The House bill's special limitation on gross foreign withholding taxes paid by financial institutions would be not only a radical departure from the principle of economic neutrality, but a totally illogical departure, because it would apply to only one form of foreign tax (gross withholding) imposed on only one kind of income (interest) realized by only one group of U.S. taxpayers (financial institutions).

The House Ways and Means Committee Report's stated goal of limiting the aggregation of one form of foreign tax with all other foreign taxes would be a fundamental deviation from the purpose of the foreign tax credit and the traditionally understood meaning of the term "equity" among persons that are subject to an income tax on their worldwide income. Successive Congresses and Administrations have affirmed the perception of taxpayers that horizontal equity in the U.S. system of taxing worldwide income of its

residents must be determined by reference to the total income tax burden -- U.S. and foreign determined separately, but with all foreign income aggregated -- rather than the residual U.S. tax liability with respect to particular foreign countries or particular foreign taxes. In testimony before the Senate Finance Committee in 1976, Secretary of the Treasury William Simon, appearing on behalf of the Ford Administration to support the mandatory use of the overall limitation on the foreign tax credit, addressed the issue well:

> The foreign tax credit is neither a tax loophole nor an incentive to invest abroad. It is merely part of a system of allocating primary taxing jurisdiction to the country within whose borders the income is earned. U.S. companies are taxable on their worldwide income. Our tax credit system does not reduce the total tax bill of U.S. companies below the amount they would have paid if the income had been earned here. The effect is that the total tax is limited to the higher of the U.S. tax or the foreign tax.*

ii. The House Bill's Special Limitation Would Distort Worldwide Lending Decisions by Discouraging or Penalizing Loans to Countries With Gross Withholding Taxes

The House bill's special limitation would impose a disincentive for U.S. financial institutions to make loans to countries with gross withholding taxes, whether high or low. That disincentive would distort decisions concerning loans to those countries and loans to other foreign countries or to the United States. There is no justification for such a differentiation between foreign countries or the kinds of taxes imposed by foreign countries.

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* Testimony of the Hon. William E. Simon Before the Senate Committee on Finance, 94th Cong., 2d Sess. 96 (March 17, 1976).

iii. The Special Limitation Would Undermine the Administration's Policy of Encouraging Investment in Developing Countries.

The vast preponderance of foreign gross withholding taxes incurred by U.S. banks is paid to less developed countries ("LDCs"). The House bill contains limited transition rules for interest accrued for periods before 1989 on certain loans to borrowers in LDCs, but these rules provide only partial protection against the adverse impact of the House bill on new and existing loans that are subject to foreign gross withholding taxes.

The House bill comes at a time when Treasury Secretary Baker is urging U.S. banks to participate in a program that would supply $20 billion of new funds to LDCs. The conflict between Secretary Baker's plan and the House bill is stark: on the one hand, U.S. banks are being asked to increase dramatically their lending to LDCs, while on the other their yields on such loans would be severely reduced by the special limitation in the House bill. The New York Clearing House respectfully urges the Treasury Department and the Congress to retain the current rules governing creditability of foreign gross withholding taxes in order to enable U.S. banks to make needed loans to LDCs, and also to continue to fund U.S. exports to those countries and other countries which impose gross withholding taxes.

iv. The Special Limitation Would Harm the U.S. Balance of Payments and Domestic Employment

U.S. banks are currently locked in fierce competition with foreign banks whose native country tax laws, capital requirements, loan loss treatment and treaty networks give them competitive advantages over their U.S. counterparts. The House bill's proposed limitation on the creditability of foreign gross withholding taxes would decrease or eliminate the already slim profit margins of U.S. banks lending abroad and force many banks out of certain foreign markets, thus directly affecting the U.S. balance of payments and domestic employment in the banking industry.

Foreign lending by U.S. banks also supports U.S. exports and overseas operations. Manufacturers and service industries depend on U.S. banks to finance their exports of goods and services and their foreign operations. If U.S. banks were replaced by foreign banks, these banks would strive to replace U.S. suppliers of goods and services with suppliers from their own countries, thus indirectly harming domestic employment and the U.S. balance of payments.

b. The House Bill's Special Limitation Would Result in Substantially More Complexity Without Any Corresponding Gains in Efficiency or Equity.

The House bill's special limitation on the creditability of gross withholding taxes would require vastly more complex computations by both financial institutions and the Internal Revenue Service than the present system. Because the House bill limits the foreign tax credit with respect to such taxes to the amount of the U.S. tax which would be payable on the associated net interest income, a separate foreign tax credit computation would be required with respect to all interest income which is subject to such taxes. While the House Ways and Means Committee Report indicates that some form of aggregation of interest income would be permitted for this purpose, it is not at all clear what it would be or how it would be administered.* In addition, the computation would require the allocation of expenses and other deductions to the interest income in question, which would be a very complex and burdensome task.

B. Current Taxation of Foreign Subsidiaries

Under present law, income that is subject to current U.S. taxation under Subpart F of the Internal Revenue Code when earned by a controlled foreign corporation includes dividends, interest, and gains from sales of stock and securities. However, such income is not subject to current taxation when it is received by a controlled corporation from unrelated persons in the conduct of a "banking, financing, or similar business." The House bill would repeal this exception, causing interest income earned by foreign subsidiaries of U.S. banks to be taxed currently, while continuing to defer the taxation of most other types of business income of foreign subsidiaries of other U.S. corporations.

1. Summary of the Clearing House Position

The foreign subsidiary income provision of the House bill should be rejected because it would impose a competitive disadvantage on foreign subsidiaries of U.S banks. No other home country of major international banking institutions imposes such a tax, nor does the United States tax the active, operating income of foreign subsidiaries of other U.S. companies on a current basis. U.S. banks are often required by U.S. or foreign laws to do business in foreign countries through foreign subsidiaries. There is no justification for the House bill's arbitrary and discriminatory treatment of foreign subsidiaries of U.S. banks.

2. The House Ways and Means Committee's Reasons for Change

The House Ways and Means Committee Report on H.R. 3838 states in its discussion of the rationale for this provision that the exception to current taxation under present law of banking income earned by foreign subsidiaries of

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* See H.R. Rep. No. 426, 99th Cong., 1st Sess. 351 (1985).

U.S. banks often provides excessive opportunities for taxpayers to route income through foreign countries to maximize U.S. tax benefits. The Committee Report erroneously states that the lending of money is an activity that can be located in any convenient jurisdiction simply by incorporating an entity in that jurisdiction and booking loans through that entity. The Committee Report further errs in stating that there is likely to be limited economic reason for the U.S. person's use of a foreign corporation.* As previously stated, U.S. banks are often required by U.S. or foreign laws to do business in foreign countries through foreign subsidiaries.

Finally, the Committee Report states that dividends, interest, and gains on the sale of stock and securities are inherently manipulable, regardless of the nature of the business earning such income. That is simply untrue as applied to banks.

3. Analysis

The foreign subsidiary income provision of the House bill would have the practical effect of imposing a competitive disadvantage on foreign subsidiaries of U.S. banks, and would impose an unjustifiable, discriminatory tax scheme on U.S banks, because the United States does not tax

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* See H.R. Rep. No. 426, 99th Cong., 1st Sess. 393 (1985).

the active, operating income of foreign subsidiaries of other types of companies on a current basis.

a. The Foreign Subsidiary Income Provision of the House Bill Would Have the Practical Effect of Imposing a Competitive Disadvantage on Foreign Subsidiaries of U.S. Banks.

In enacting the Subpart F provisions of the Internal Revenue Code in the Revenue Act of 1962, Congress recognized the need to maintain active American business operations abroad on an equal competitive footing with other operating businesses in the same countries.* In enacting the exemption for banking businesses, Congress implicitly recognized that the deferral of U.S. tax on such income is necessary to maintain foreign subsidiaries of U.S banks on an equal competitive footing with subsidiaries of other financial center banks operating in foreign countries. The only change that has occurred subsequent to 1962 is that international banking competition has become more intense with advances in transportation and communications and increases in the number of competitors. No other home country of major international banking institutions imposes such a tax. Therefore, the foreign subsidiary income provision of the House bill would have the practical effect of imposing a competitive disadvantage on foreign subsidiaries of U.S. banks and should be rejected.

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* See S. Rep. No. 1881, 87th Cong., 2d Sess. 83 (1962).

b. The Foreign Subsidiary Income Provision of the House Bill Would Impose an Unjustifiable and Discriminatory Tax Scheme on U.S. Banks, Because the United States Does Not Tax on a Current Basis the Active, Operating Income of Foreign Subsidiaries of Other U.S. Companies.

The United States does not tax on a current basis the active, operating income of foreign subsidiaries of U.S. companies. The House bill's proposed repeal of the exemption for income derived in a banking, financing, or similar business is intended to treat interest income derived in such a business as passive rather than active. But interest income derived in the banking business of a foreign subsidiary of a U.S. bank is in reality active, operating income which should not be subject to current taxation if the active, operating income of subsidiaries of other U.S. companies is not subject to current taxation. The House bill would impose an unjustifiable and discriminatory tax scheme on foreign subsidiaries of U.S. banks, which should be rejected by the Senate.

III. Commercial Banks Pay a Fair Share of Taxes

The House bill's provisions which would single out commercial banks for adverse treatment in comparison with other corporations apparently are based on a misconceived premise that commercial banks do not pay a fair share of taxes under the present tax law. The misconception is often based on so-called effective tax rate studies such as ones sponsored annually by Congressmen Pease and Dorgan and ones

prepared by the Joint Committee on Taxation. Those and most other effective tax rate studies ignore two very large indirect taxes which are borne by the banking industry, but not other corporations, namely:

(1) The interest foregone on reserve deposits which depositary institutions are required to maintain with the Federal Reserve System. The interest earned by the System from investment of the deposits, primarily in government securities, is paid over to the Treasury as revenues, just like federal tax revenues.

(2) The interest foregone on tax-exempt state and local obligations held by banks. The lower yield that banks receive on these obligations because of the tax exemption is the economic equivalent of taxing the interest and turning over the tax revenues to the state and local governments.

A survey conducted by the Bank Administration Institute while Robert Quinlan, who accompanies me here today, was Chairman of its Tax Commission, demonstrated that, based upon 1982 data, when the Pease-Dorgan figures are adjusted to take account of these two implicit taxes, commercial banks pay an effective tax rate at or above the 46 percent rate. Surveys for 1983 and 1984 have generated similar results. It is not only unfair, but distortive of any rational analysis, to disregard these very real and very significant taxes that are borne by commercial banks, but not to any comparable extent by other corporations.

Maintaining reserves with the Federal Reserve System is mandated by law for all depository institutions.* As noted by Paul Volcker in his September 13, 1983 statement before this Committee:

> Reserve requirements, while imposed for monetary policy purposes, also, from the viewpoint of the depository institution, represent a form of tax that falls unevenly across institutions providing comparable services. Interest on required reserves would remove this competitive distortion.

In the case of my own institution, during 1985 we maintained average reserve balances with the Federal Reserve System of $474.7 million. When the Federal Reserve's average rate of return on all assets of 8.22% is applied to these reserves, this results in an implicit tax imposed on Chemical New York Corporation of $39 million. Speaking for Chemical, we would be quite happy to receive interest on these reserves and pay federal income taxes on such income.

Congress has made a public policy decision to subsidize borrowings by state and local governments. Banks have traditionally been significant holders of municipal securities. The interest foregone by banks on tax-exempt obligations, representing the difference between a taxable yield and a tax-exempt yield, is an implicit tax on banks and other holders of such obligations. A Federal Reserve study has noted that this foregone interest is a tax which is paid to the issuers of the municipal bond and which is properly added to other taxes in computing the burden of taxation. Similarly, many commercial banks have, for many years now, reported earnings from municipal obligations on a "taxable equivalent" basis, so that there will be comparability in their financial reporting between interest on such investments and other fully taxable earnings. In the case of Chemical New York Corporation, this second implicit tax amounted to $232 million for 1985.

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Thank you again Mr. Chairman for the opportunity to represent the views of The New York Clearing House here today. I hope our comments have been helpful, and I would be happy to answer any questions that you or other members of the Committee may have.

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* Federal Reserve Act §19(b)(1), 12 U.S.C. §461(b).

The **Chairman**. Thank you, Mr. Shipley.

Gentlemen, Mr. Shipley mentioned the indirect taxes paid because of reserves that are held without any interest and stated that his position was such that he would prefer to have interest on reserves and pay taxes on that.

Would that be the position of the rest of you?

FED SHOULD PAY INTEREST ON RESERVES

Mr. **Senterfitt**. Mr. Chairman, in the past, many segments of the banking industry have called for legislation requiring that interest be paid on the reserves that are maintained at the Federal Reserve.

The **Chairman**. Well, would you prefer that to the current situation? Would you prefer to pay taxes and have interest on reserves rather than accept some of the changes the House is talking about?

Mr. **Senterfitt**. Yes, almost anything would be preferable to the House changes, Mr. Chairman.

The **Chairman**. Well, I think you probably all know former Senator John Tower and I used to introduce a bill virtually annually that would require the Federal Government to pay interest on those sterile reserves to compensate for that indirect taxation and loss of income.

Mr. Backlund, what is your opinion on that?

Mr. **Backlund**. The reserves held by small banks are not substantial because we have an exemption where we can use our cash in vault. So I would abstain from taking a position at this time, but it certainly sounds like a lot of logic to it, but we have no position and I really don't know what the impact would be on the smaller banks. It probably wouldn't receive—the interest on their reserves that are held by the Fed would probably not be substantial for a small bank.

The **Chairman**. Mr. Macy, do you have any position?

Mr. **Macy**. Well, I don't think the AICPA would have a formal position. It certainly has conceptual logic and merit to what you're suggesting however.

The **Chairman**. Mr. Shipley, your organization has been especially concerned with the gross foreign withholding tax credits which would be reduced by H.R. 3838. Some tax analysts have argued that current law is not economically neutral because it provides for excess credits arising from foreign loans which can be applied to reduce U.S. tax payments. The consequence is that banks make otherwise economically unsupportable foreign loans because of the tax credit, and foreign countries' taxes are subsidized at the expense of U.S. taxes.

Do you agree with that analysis?

Mr. **Shipley**. No, I do not, Senator. The foreign tax credits are applicable to foreign source income, not to domestic source income.

The **Chairman**. So you would not agree that, as some would say, you can offset?

Mr. **Shipley**. That's correct. If I could add a comment on your former question, while I made the statement, I would just say that from our point of view I would go so far as to say that revenue neutrality on this issue of reserves if the payment of reserves and the taxes on reserves would help in enhancing the understanding of the true taxes that are paid by the industry I think that ought to be the objective.

The **Chairman**. Mr. Backlund, your No. 1 concern with the tax bill is the repeal of the special net operating loss carryover provisions for financial institutions. You point out that especially in these days the ability to carry over losses can be the difference between continued operations and failure of a marginal bank.

If you had to compromise on this issue, do you have any recommendations? If we're not able to kill it completely, do you have any compromise position?

Mr. **Backlund**. Well, anything—now, in H.R. 3838, as I recall, it goes back 3 years. It's a carryback for only 3 years. I think that's correct. Well, anything more than 3 years would be of help, but the thing you have to realize, I think bankers are finally realizing what a risky business banking is. It's a highly leveraged business, millions of transactions going through every day frought with risk. There is a growing cadre of young attorneys out there looking for juicy lawsuits and banks are a prime target.

The **Chairman**. I thought we had all the attorneys in Congress.

Mr. **Backlund**. Well, you have a number of them but not enough I would say. And I think we are finally realizing how risky it is. You do have good profits during these periods, like we had during the 1970's, but they really were an illusion in a sense. Our bond portfolios were going down in price, the agriculture loans we were making actually had problems that we didn't realize. So you definitely do need, especially in these periods where economic cycles are very, very long, to go back over a long period of time because those profits you make can really very often be an illusion as you look back on it.

So I submit that you do keep in mind, that really the name of the game of banking is risk management and a lot of those risks cannot be anticipated. That's why we need to go back as far as possible.

The **Chairman**. Senator D'Amato.

Senator **D'Amato**. Thank you, Mr. Chairman.

I'd like to make an observation. It seems to me that I haven't seen anybody who doesn't start off by saying that, "While we are most supportive of the principal objective of tax reform," and then they slide off into their own special area as to why the bill is bad, whether it's accelerated depreciation or investment tax credits that will hurt in the case of banking institutions.

BILL FULL OF THROWAWAYS

I'm just going to give you a little thought on my part. I think for the most part this bill is going to pass. Everyone is going to get a little piece of the porridge. This is a throwaway. They're going to give this back to you. I think that the situation—it's so shocking that I think it was almost deliberately—I don't believe anybody could be so stupid as to put in these provisions that fly in the face of everything they are attempting to do on one hand, and I think that it's a rather crafty way—there are no revenues involved to speak of. You all attested to that. I think you said at the most it could be $100 million and why destroy the system when you're looking to raise $20 billion for foreign loans? Everything we're looking to do—soundness in the banking system—is attacked as a result of this. You'll raise the cost of municipal financing incredibly. This is nothing more than at some point in time the Treasury people will meet with you. You will all come together and they will say, "Well, fellows, you know, if you're going to support the bill we'll do away with this." And you know what's going to happen? You're all going to support the bill because you got your little piece and that's going to take place in area after area and, of course, the totality of whether the bill is good or bad—that's another matter. Everyone has taken care of his little special interest and that's what I fear, Mr. Chairman, is going to be the case.

That's how you got this H.R. 3838, because the members of the Ways and Means Committee all had their little special thing and some of them very important, and I'm not suggesting they were not important considerations, and when the chairman said, "Now look, fellows, this train is pulling out and either you're going to be onboard and we'll take care of your special interest, but if you don't get onboard, the bill is going to pass anyway and your concern with respect to your State or your municipal project or the eight or nine projects that they grandfathered and left the tax accelerated depreciation and writeoffs continue"—I think the bill is a bad bill. Why don't you say it instead of hedging this with all this "while we are for the principle," sure, we're all for God and motherhood and the flag and no excess interest payments, they don't have to be made.

You know, if this thing passes, you'll just have to raise credit card interest charges even higher, Walter. That's why I'm opposed to this. You'll have to make that money some place.

Anyway, I gave you my speech on that and I just think that the business community is to blame if this bill passes because everyone is afraid. They're all shrinking off on the side and looking to protect their little thing and you may get a little piece of it protected but you're going to get a pretty bad bill for the American economy if things continue this way.

If Congress adopts the elimination of the interest expense deductions, what will the effect on the banks' ability to purchase or trade in tax-exempts issued by State and local governments be and what happens to the cost of issuers? Mr. Macy, would you give us an idea as to what you think that cost might go up?

Mr. MACY. It's difficult to estimate the dollar amount of the increase in the cost, but clearly for the banks to be investing in municipals for which they receive no tax-free interest income or another way of putting it, they must pay tax on a higher amount of income, will create an environment in which banks will be reluctant to invest unless the yields on those municipals increase.

I can't put a precise number on it. Perhaps Mr. Shipley could give a better quantification of it, but I can't imagine that if they have alternative investment opportunities that they're going to want to put their money in low-yielding municipals and then have to pay tax on that interest anyway.

Mr. SHIPLEY. That's a very hard one to count. It's somewhere between—I mean, you would relate the comparable maturity to a Treasury issue and you'd have to weigh the comparable risks against a Treasury issue and in both cases—in the latter case, it would be a higher rate. But banks are not the only holders of municipals. They hold a substantial proportion of them. It would be a real disincentive for us to do so and so you would have an upward pressure.

I do not say it would rise to all the way. It's not as if you were completely removing all tax incentive from holding securities because individuals would still hold them and still have some tax benefits.

So I think it's hard to be precise.

Senator D'AMATO. I'm wondering if you might not be able to make a study and give us something on that in the future as to what that rise might take on because I think it's important.

Mr. SHIPLEY. It would be about worth what the paper is, but we would be happy to do it for you.

Mr. BACKLUND. Senator, that would particularly affect, as I pointed out, the small municipalities who do have a rather limited market for their securities. Traditionally, the banks in the community have bought the shorter term issues and provided a market. And now, of course, the banks with this provision are just out of it. We won't be able to buy tax-exempt securities.

So I think the effect will be most dramatic with the very small municipalities. That's why this exemption they have for 3 years for smaller municipalities could be important if made a permanent part of this whole provision.

COST UP 2 PERCENT ON MUNICIPAL BONDS

Senator D'AMATO. Some people have estimated that the cost might go up as much as 2 percent in certain cases. Would you think that would be in the area?

Mr. SHIPLEY. Absolutely. As a matter of fact, the figures that I used when I imputed the cost to Chemical or the effective tax to Chemical of its municipal portfolio was using a 46-percent effective tax rate and taking the yield that you had on our portfolio, you would use a gross up factor to get a tax equivalent yield and you use roughly 85 percent as a gross up to income against which you would then have your 46-percent tax rate to come back to the yield that we had in fact earned on that.

I'm not saying that all of that is what would happen as far as the rate is concerned, but somewhere between that and where it is, and significantly on the higher side toward the gross up figure.

Senator D'AMATO. Mr. Chairman, you know as a former local public official what that takes on, a 2-percent increase in what the bond indebtedness costs are just in many cases makes the difference to the municipality as to whether it can go forward with a project or not and results, depending on the size of that municipality and the size of the issue, in millions if not tens of millions of dollars in increased cost all picked up by the local taxpayer, and for the most part, the homeowner, the property owner, because that is the largest revenue source.

I just see it as a terrible blow to working middle class families, to homeowners in particular, and I think it's something that our friends at Treasury had very little concept of when they were tinkering with this and I think it was nothing more than an attempt to pander to the public to say we're going to get the banks because they're not paying their fair share.

Now I think there are lots of things we should get after you about, you know that, but not this, not when we're looking to move to create a situation where we're asking for soundness in the banking system and we're asking you to write off the debts, we're asking you to increase your capital—this flies in the face of these provisions in doing that.

Mr. Chairman, I have a number of other questions I would like to submit for the record and again I'd like to commend the chairman and thank him for calling these hearings at this point in time so we can begin to focus in on the effects of the Treasury proposal and the bill which the House has passed.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman. I, too, want to commend you on this because I think these hearings are very important. A lot is being brought out. First of all, the taxation issue. When I first came to Washington and got on this Banking Committee 3 years ago that was my first surprise. I got here and I heard a speaker talk about why banks should pay taxes and the fact that they don't pay taxes and I came out of 25 years of banking and I said, "We paid tens of millions. I'll tell you what you do, you go to the IRS and say this bank by mistake paid all these taxes and I'll give you half of what you get back." Of course, I never heard from them.

So this is a perception in Washington that I think should be acknowledged.

PRESIDENT WILL VETO PRESENT BILL

As far as this bill is concerned, it's hard to focus on it because we don't know exactly what's going to be. As the President said, the present bill he's going to veto if it comes to his desk. I'd like to urge all of you during the hearings of the Finance Committee to put your 2 cents to it and explain to them how important this banking structure is and just talking to Jerry, one of the questions I was trying to get organized in my mind, if the assets of a bank in 1 year are $460 million and they have a good growth rate and next year it's $510 million, are they taxed on $10,000 or are they taxed on the $510 million, were they taxed on the reserves? There are so many things that have to be brought out that it's going to take a tremendous amount of work and I don't have any questions for all of you today but I urge you to go back to the Finance Committee and bring all these things out.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Hecht.

Following on what Senator D'Amato said about each group following up its own interest, that's understandable because if you don't, no one else is going to look out for you. Besides, we specifically asked you to come here and testify on the effects of H.R. 3838 on your industry, as we have with other witnesses. Like you, I, too, make the same statements, that I'm in favor of reform and simplification, but I don't think this bill overall—forgetting anybody's particular interest—meets those tests other than in a very narrow way of reducing the number of income tax brackets. That's it. That's the only simplification there is. Otherwise, it looks to me like they've hired a new interior decorator to come and move the furniture around the room—no new furniture, just rearranged and put it in different places.

So looking at the total bill in its present form, do each of you agree that it does not meet those tests other than in the very limited way I mentioned, and is a bad bill for the economy?

Mr. SENTERFITT. We do indeed, Mr. Chairman. While we have emphasized today the effects on the banking industry, I would like to point out that the people who are really going to suffer are the individuals, the municipalities, and the small and larger businesses. It's not just a matter of pure self-serving on our part, although we naturally as the chairman has suggested are interested in the viability, health, and financial profitability of our industry.

The CHAIRMAN. Unless any of you would like to speak, I would note for the record that everybody nodded that it was a bad bill.

Mr. SHIPLEY. I cannot—you're asking us personally now, not representing our associations?

The CHAIRMAN. Right.

Mr. SHIPLEY. I agree with you.

The CHAIRMAN. You look like a person to me. You don't look like Chemical Bank sitting there. Chemical Bank has never spoken to me.

Mr. SHIPLEY. I am here representing the Clearing House, Mr. Chairman.

The CHAIRMAN. One other point that Senator D'Amato was talking about, as a former mayor, I do wholeheartedly understand the impact on local government. Because of its retroactive effective date, H.R. 3838 is already having an impact because of the uncertainty. Bond issues are not being sold and extra interest rates are raising the cost of capital for local governments to the tune of many millions of dollars.

As Mr. Senterfitt pointed out, local government doesn't pay taxes. People pay taxes. Local government primarily relies on the property tax. That was the major source of my revenue to run Salt Lake City. So that's why I get back to talking about rearranging the furniture. That is basically all we're doing in this bill, rearranging the furniture and trying to kid the American people that their tax burden is going to come down. It may come down in one place, but it will then increase property taxes in another. Everybody seems to agree that property taxes are rather regressive compared to an income tax. In fact, it amazes me that the House of Representatives could produce a bill like this, and that the press in many cases would continue to portray it as being fair and as changing the Tax Code. It is just shifting the burden around, but ultimately the people are the only ones that pay taxes. In the area of municipal finance, H.R. 3838 means moving back to a property tax, even though all across the country there have been referendums like proposition 13 in California to limit the increase in property taxes.

The only way I can explain it is that there are gnomes down in the bowels of Treasury that have no windows to the outside world.

They never meet or talk to real people and a new President is only a minor irritation to them because they will still be there when this President is gone and the next one is gone. So they come up with their favorite proposals and in Treasury I, Treasury II, and in H.R. 3838 there isn't one single new idea that hasn't surfaced in every Congress that I have served in. There's no new light or sunshine out of the bowels of Treasury. Maybe we ought to dig a tunnel down there sometime and open up the outside world to some of those gnomes. I don't even know whether they have long ears or are bald or whatever they are, but the baloney they pump out of that organization is incredible and this bill does have a serious impact on many aspects of our society. I can't believe the House of Representatives passed it.

So I guess we need a new House of Representatives.

Gentlemen, thank you very much. We appreciate your willingness to testify.

If we could have the cooperation of the people in the hearing room, we do have two more panels to be heard today.

Our second panel is composed of Charles H. Miller III, head of trade finance, Philadelphia National Bank, representing the Bankers' Association for Foreign Trade; Alberto Parracchini, president and chairman, Banco de Ponce, representing the Puerto Rico Bankers Association and Puerto Rico League of Savings Institutions; and Johann H. Brinckmann, executive vice president of Amsterdam, Rotterdam Banks; chairman, Institute of Foreign Bankers.

Gentlemen, we are happy to have you with us and, Mr. Miller, if you would like to begin, please.

STATEMENT OF CHARLES H. MILLER III, HEAD OF TRADE FINANCE, PHILADELPHIA NATIONAL BANK, PHILADELPHIA, PA, REPRESENTING THE BANKERS' ASSOCIATION FOR FOREIGN TRADE

Mr. MILLER. Thank you, Mr. Chairman.

I am Charles Miller and I am representing the Bankers' Association for Foreign Trade, commonly referred to as BAFT. This is a U.S. organization which was founded in 1921. We have 135 voting members which are virtually all of the U.S. banks active in international banking and international trade finance.

My bank, the Philadelphia National Bank, a very old bank founded in 1803, in term of deposits is the 37th largest bank in the United States with deposits of $5.3 billion. We have 65 domestic branches in southeast Pennsylvania, 5 international branches or subsidiaries. Internationally, we specialize in trade finance, which is used to support our regional and national customers' export sales. My responsibility is as manager of the trade finance group.

BAFT OPPOSES SECTION 602 OF H.R. 3838

BAFT's position is that we strongly oppose section 602 of H.R. 3838 because it severely constrains the ability of U.S. banks to finance our domestic customers' export sales by limiting our ability to take a foreign tax credit for withholding taxes paid by U.S. banks in foreign countries, unlike many non-U.S. banks whose countries' laws provide for a full credit for withholding taxes.

I think Senator D'Amato's comment with respect to the severity which this change could have on U.S. banks, is more imminent than we seem to think. It's not only the extent to which this bill, if passed, at that point in time could have these limitations on us. Let me explain what the current situation.

Because H.R. 3838 which has an effective date of November 16, 1985, has passed, we and many other regional banks have, as of the beginning of this past, year, stopped supporting many of our customers in their export sales for potential exports to those countries which are imposing a withholding tax on us as the lender—which is roughly 50 countries to which the United States has major exports—which countries impose withholding taxes on U.S. lenders abroad.

I think it is important to recognize that seeing that this bill has already passed, we have stopped doing a certain amount of business. It has begun to impact us already.

MEANING OF TRADE FINANCE

Let me explain briefly what trade finance is and how it differs from general international lending.

Trade finance is essentially export finance. It's done by regional banks and money center banks alike. It's done by U.S. banks and foreign banks alike. It is one of the oldest forms of international lending and it is one of the most specialized areas of international banking.

Essentially, export or trade finance is supporting an exporter with a financing package to assist them in selling their goods to foreign markets.

Why do we provide it? Very simply, our mandate is to meet the needs of our customers. Particularly for large regional banks where our primary business base is here in the United States our need is to meet their demands. They are now telling us as a community that what is required of their U.S. banks is to assist them in providing export finance packages to buyers so that their products are more competitive. So we are merely meeting their requirements.

Let me explain further how export finance and trade finance works. In order for an exporter to meet his customer's requirements he has to provide a competitive price and competitive financing terms. By that, I mean that many times the buyer imposes upon the exporter the requirement to provide credit terms. The exporter doesn't necessarily like to be in that position. They do not like to be in the position of having to play the banker. So they look to their bank, and particularly the trade finance specialists at that bank, to structure a financing package to finance the buyer to take them, the exporter, off the hook so that they can be paid in cash.

I think most importantly over the last few years, because of the international debt situation, the reality of the world seems to have become that the buyers are receiving from their host governments the requirement that if they are to import they have to receive credit terms.

Let me give a further example. In 1980, a commodity or chemical sale made by a United States exporter to a company in Brazil would probably have been made on cash terms. The Brazilian buyer would have purchased the United States dollar spot, financed the purchase in his local currency, and the United States exporter would have been paid in cash upon shipment.

Since then, because of the debt problems in Brazil, the Brazilian Government has imposed the requirement upon the buyer that if he is to buy the product from the United States supplier or any exporter that he must not only get competitive terms on price but that he must receive financing. And in the case of certain products, it would be generally for a minimum of 180 days, sometimes longer, sometimes medium terms, depending upon the nature of the equipment. Without both the competitive price and the financing terms provided by the exporter, the sale cannot take place.

Let me reiterate. Exporters must have competitive pricing as well as competitive financing terms in their sales package.

BILL IMPACTS BANKS ABILITY TO FINANCE EXPORTS

How does H.R. 3838 impact our ability to finance as a bank? In countries which impose a withholding tax, the legal liability to pay the tax is on the lender, not on the borrower. So the ability of the bank to pay the tax can be crucial to the competitiveness of the financing package.

As further examples, on pages 6 and 7 of this testimony I have cited two instances of a tobacco sale and a coal sale. Let me use the tobacco sale as a reference. In that situation, a United States exporter selling tobacco to Australia is required by the buyer to submit financing terms. The buyer in Australia is telling all of the prospective vendors of tobacco in the United States or any other country that if they want to meet the terms to sell their tobacco they have to provide 180-day credit. The exporter then goes to his U.S. bank, specifically to the trade finance department of that U.S. bank and he says to his banker, "I'm not interested in extending credit. Will you extend the credit on my behalf directly to the buyer, give me a financial package so he can buy our product?" The U.S. bank assessing the credit quality of the buyer makes a determination that in order to obtain the sale with the financing the maximum rate they can charge is 50 basis points or one-half of 1 percent over the London interbank offering rate which generally is our marginal cost.

We know that Australia imposes a 10-percent withholding tax on the interest payment which the buyer will make to us, the bank; once again, the tax is on us, the lender, not on the buyer. The buyer pays us the London interbank offering rate plus one-half of 1 percent. The bank then pays the withholding tax to the Government of Australia.

So without the bank's ability to take the full tax credit, the yield will be below our cost of funds. In this situation, under H.R. 3838 either the bank will not lend or we would have to increase the spread to the buyer over the one-half of 1 percent to cover the cost of the tax since we would not be able to use the credit. This would obviously result in us being uncompetitive since a foreign lender supporting a foreign sale would be able to use the tax credit and could provide more competitive financing terms to the Australian buyer.

The result: U.S. exporters would either lose the sale or would have to work through foreign banks which can use the full tax credit to offer competitive terms to the buyers in those countries.

Let me reinforce and reiterate the primary purpose and objectives of trade finance. First, it is to support our domestic customer base of manufacturers and producers, not who export but to export.

Second, financing is required by the buyer and many times is a key element to export competitiveness. The ability to take the full tax credit for withholding taxes we pay to foreign governments directly impacts on the pricing of our financing.

H.R. 3838 as written would provide a major advantage to foreign lenders to support their exporters over U.S. exporters. So, if H.R. 3838 passed, U.S. exporters will have to rely greatly on foreign banks for their export competitiveness.

In closing, let me simply state that since other countries will continue to allow a full credit for a withholding taxes paid by their banks, we will be playing on an uneven playing field. U.S. banks will not be as competitive so U.S. exports will suffer. Thank you.

[The complete prepared statement follows:]

STATEMENT OF
CHARLES H. MILLER, III
PHILADELPHIA NATIONAL BANK

ON BEHALF OF THE

BANKERS' ASSOCIATION FOR FOREIGN TRADE

ON
H.R. 3838

THE TAX REFORM ACT OF 1985

Committee on Banking, Housing
And Urban Affairs
United States Senate

February 5, 1986

Mr. Chairman and Members of the Committee:

My name is Charles H. Miller, III and I am pleased to appear today on behalf of the Bankers' Association for Foreign Trade ("BAFT") to present our views on provisions of H.R. 3838, the "Tax Reform Act of 1985," that will significantly affect the international activities of BAFT member Banks. The BAFT, which has been in existence since 1921, is a trade association of money-center, regional and smaller banks dedicated to promoting international trade and finance. Its 135 U.S. voting members comprise virtually all U.S. banks actively engaged in international banking and trade finance.

I am a member of the International Taxation Task Force, which has been analyzing the impact that various tax reform proposals, including H.R. 3838, would have on the international lending and trade finance operations of our U.S. bank members. As head of trade finance for Philadelphia National Bank, I have also examined in some detail the impact that H.R. 3838 will have on my bank's ability to finance the exports of our regional and national U.S. customers, and I have held extensive discussions with my counterparts at other financial institutions who are similarly concerned about the adverse effects of H.R. 3838.

Mr. Chairman, as stated in BAFT's letter of January 13, 1986, from an international competitive standpoint, our U.S. members' greatest concern is with section 602 of H.R. 3838, which would cause a significant change in current U.S. tax law by denying U.S. banks foreign tax credits for gross foreign withholding taxes on foreign loans in excess of the U.S. tax on the net interest income of such loans.

There are many compelling reasons for opposing section 602 of H.R. 3838: it is contrary to sound tax policy; it is discriminatory because it is directed solely against banks and other financial institutions subject to withholding taxes on cross-border loans; and it is unfairly retroactive. However, in my statement today, I would like to focus my remarks on an area within the Committee's jurisdiction which is also of paramount concern to BAFT's U.S. members; namely, the very damaging impact which section 602 will have (in fact, already is having) on the ability of U.S. banks to finance U.S. exports in highly competitive international markets. In this connection, our concerns with respect to section 602 apply as well to the President's proposed per country foreign tax credit limitation, which was strongly opposed last year by business and banking industry witnesses before the tax-writing committees of the House and Senate.

THE SCOPE AND IMPORTANCE OF TRADE FINANCING

Financing is a critical competitive component in almost every export sale. Intense foreign competition and debt problems abroad generally require that foreign buyers of U.S. commodities and goods be quoted an "all-in" price that includes financing. U.S. exporters of commodities and goods have therefore turned to their U.S. bank lenders to provide this crucial financing component and to assume the associated buyer credit risk. Money-center, regional and smaller banks are meeting this need through increased emphasis on internationally competitive trade financing.

This emphasis is revealed in statistics on U.S. bank lending abroad. As of June 30, 1985, U.S. banks had $324 billion in total claims on foreign borrowers. Over 60 percent of the claims had a maturity of one year or less with the majority representing short-term credits facilitating exports. Of the total claims, $103 billion were to non-OPEC lesser developed countries (LDCs). Of that amount, 47 percent had a maturity of one year or less. In this connection, as measured by total international assets, U.S. banks have been losing market share and are now second to Japanese banks in the international market. See Exhibit A.

Proposals to deny U.S. banks foreign tax credits for foreign gross withholding taxes would have seriously adverse effects on U.S. bank export financing to countries which impose such taxes -- [countries which account for virtually all U.S. exports]. In fact, House passage of H.R. 3838 has already caused some U.S. banks to stop export financing involving withholding tax considerations, because of the legislation's retroactive denial of foreign tax credits for gross withholding taxes.

In my statement this morning for BAFT, I would like to explain how and why reduced foreign tax credits in international lending will, in turn, cause a significant reduction in private bank financing of U.S. exports.

PROPOSED CHANGES TO THE FOREIGN TAX CREDIT

Like other taxpayers, U.S. banks that engage in international activities are subject to foreign taxes on income produced from such activities and are also subject to U.S. income tax on the same income. The foreign tax credit is the tax mechanism by which relief is obtained from the double taxation of the same income that would otherwise occur.

Current law entitles U.S. taxpayers, including banks, to take a credit against U.S. taxes for taxes paid to foreign countries on income earned in those countries. The credit is calculated on an overall basis, meaning that the credit is determined by adding together all of the creditable taxes paid to all foreign countries. The credit that may be claimed, however, cannot exceed the total U.S. tax on the taxpayer's foreign source income. Thus, credits are not used to reduce U.S. tax on U.S. income.

Fifty foreign countries impose gross foreign withholding taxes on interest paid to lenders outside the country. See Exhibit B. The United States also imposes such a tax. When a U.S. bank extends a cross-border loan to a buyer in a withholding tax country to purchase U.S. commodities or goods, the bank becomes liable for payment of the withholding tax.

Under current U.S. tax law and regulations, U.S. banks are able to take a foreign tax credit for gross withholding taxes paid abroad on interest which they receive or accrue. This availability of a credit prevents double taxation of the same interest income and gives U.S. banks the same right as other U.S. taxpayers to include such withholding taxes in the calculation of their overall tax credit limitation. While taxation systems differ among countries, the present U.S. foreign tax credit for withholding taxes is comparable to the treatment of such taxes currently employed by our major export competitor countries -- Japan, the United Kingdom and major exporting countries in Continental Europe.

Section 602 of H.R. 3838 would disrupt this competitive balance by imposing an artificial limit on the amount of withholding taxes that could be claimed as a foreign tax credit by a U.S. bank. Specifically, under section 602, no foreign tax credit is allowed for any foreign gross withholding tax imposed on interest income received or accrued by a U.S. bank, to the extent that the tax exceeds the U.S. tax which is attributable to the associated net interest income. Foreign tax credits disallowed under section 602 will be treated as non-creditable taxes that cannot be carried back or forward or deducted from foreign income. Such disallowed taxes thus become an expense of cross-border lending to a withholding tax country borrower which either must be absorbed entirely by the U.S. bank or passed on to the borrower in higher pricing.

ADVERSE IMPACTS OF CHANGES IN THE FOREIGN TAX CREDIT ON EXPORT FINANCING

If U.S. banks are denied a foreign tax credit for the withholding taxes they pay abroad they will not be able to extend competitive financing in support of U.S. exporters, because the competition will not allow them to pass this additional cost on to foreign buyers. In this connection, the following examples from some of our member banks are instructive:

- A regional bank in the Southeast finances exports by a tobacco dealer, who purchases tobacco from U.S. farmers. The tobacco is to be sold to an Australian buyer, who can also obtain similar grade tobacco from Brazil or Korea. Australia imposes a 10 percent withholding tax. Because the Australian buyer is an excellent credit risk, he can demand top market terms from his competing suppliers and their banks. In this case, to be competitive, the U.S. bank quotes the Australian company a rate which is 50 basis points over its cost of funds. This results in a competitive market rate. This competitive rate does not include the cost to the bank of the Australian withholding tax which also must be paid by the U.S. bank. If the U.S. bank could not obtain a tax credit for the withholding taxes paid in this transaction, it would have to pass the costs on to the borrower, else the loan would be made at a loss. However, competition from foreign suppliers will not allow this cost to be passed on, since foreign banks financing such suppliers can absorb the cost of the withholding tax under their tax systems. The result is U.S. bank financing is not available for this export.
- A regional bank in the mid-Atlantic states discounts foreign trade receivables for a major U.S. coal exporter. Many countries to which the coal is being exported impose a withholding tax on the interest paid on such receivables. These taxes are paid and absorbed by the U.S. bank because of intense foreign competition

in commodity export sales. Again, if the U.S. bank were denied a tax credit for the withholding tax paid, the U.S. bank could not absorb the tax and its pricing would be non-competitive and the export sale would be lost to foreign coal exporters and their banks which could absorb the cost of the withholding tax under their tax system.

Countless other examples could be given and, in each, the result would be the same. Unilateral changes by the U.S. in its foreign tax credit rules will prevent U.S. banks from extending competitive financing to their U.S. customers and export sales will be lost. In this regard, as the examples above illustrate, trade financing is done to a great extent by regional and smaller banks which are close to their local corporate customers. Regional banks play an especially critical role in financing the exports of smaller business concerns new to the export market. Thus, reduced tax credits in international lending not only would cause our existing exporters to lose sales but also would prevent newer and smaller companies with export potential from ever reaching the export market.

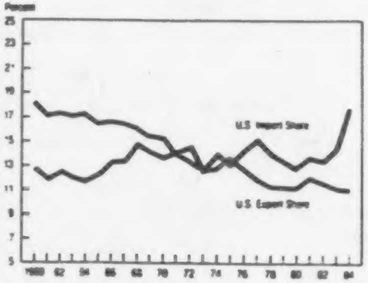
The effects of a reduced foreign tax credit for foreign withholding taxes is likely to be particularly severe on capital goods exports, which account for almost 30 percent of total U.S. exports (1984). Multinational companies with production capabilities worldwide will generally adjust the sourcing of those facilities based on many variable costs, one of which is financing. For example, a U.S. auto manufacturer with an assembly operation in Mexico has been purchasing components from affiliates in Japan and the United Kingdom. Financial institutions in both Japan and the United Kingdom are able to absorb the withholding tax on interest charged by the Mexican government under their tax systems, thus lessening the financial costs of such purchases. When a U.S. bank was able to make the same type of financing available, the Mexican company began sourcing some of the components from the United States. Provisions such as section 602 of H.R. 3838 would prevent U.S. banks from extending such competitive financing and would thus force more sourcing to occur outside the United States. Provisions such as section 602 of H.R. 3838 would result in more U.S. jobs — not more U.S. goods and commodities — being exported from the United States.

ADVERSE IMPACTS ON U.S. EXPORTS

Trade balances are one indicator of a nation's competitiveness in world markets. Large trade deficits indicate a nation's inability to sell abroad as much as it purchases from abroad. As Chart I illustrates, U.S. competitiveness has steadily declined since 1960 as measured by its share of the world market of exports and imports.

CHART I

U.S. SHARE OF WORLD EXPORTS AND IMPORTS 1960-84



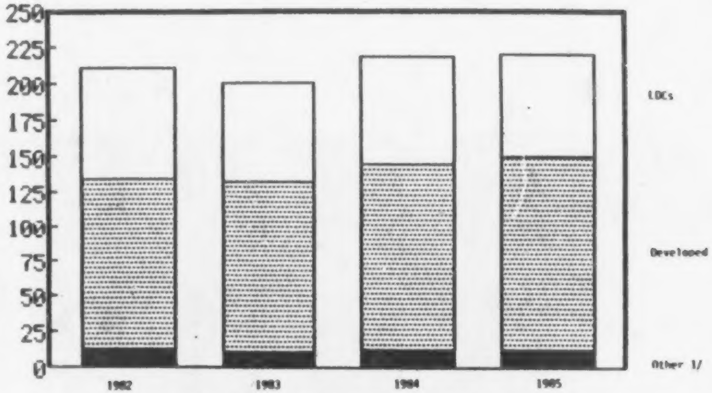
Source: United States Trade Performance in 1984

U.S. Department of Commerce, 1985

Of the countries imposing withholding taxes, 23 are industrial countries, 26 are LDCs and one (1) is a centrally-planned economy. For 1984, U.S. exports to all industrial countries accounted for 61 percent of total U.S. exports, while exports to all LDCs accounted for 33 percent of total U.S. exports (see Chart II).

CHART II

TOTAL U.S. EXPORTS BY COUNTRY CATEGORY



1/ Other includes special category or military type goods exported and included in total U.S. export figure, but not allocated to respective recipient country. Also includes exports to centrally planned economies.

Estimated 1985 annualized figure based on January through June

Source: U.S. Department of Commerce, U.S. Foreign Trade Highlights, 1985

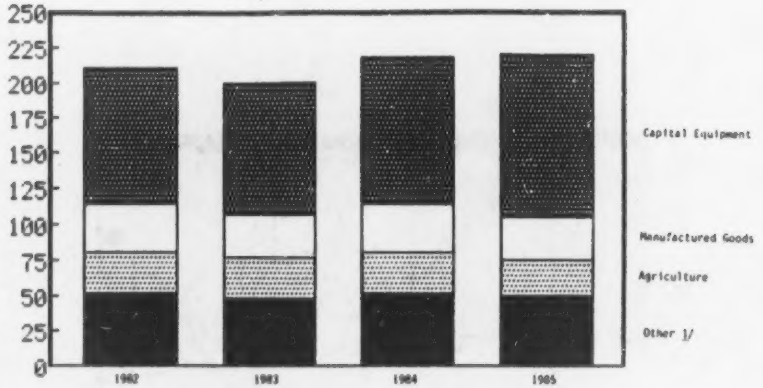
The importance of U.S. trade is not only in terms of the balance of trade statistics but also as to how exports translate into U.S. employment. Statistics recently published by the Department of Commerce indicate the importance of remaining competitive in foreign markets for the employment considerations that result from the export of U.S. goods and services.

- o **MERCHANDISE EXPORTS** accounted for nearly 25,000 U.S. jobs per $1 billion of U.S. merchandise exports. One out of every eight jobs in manufacturing is attributed to exports, or in aggregate terms, merchandise exports accounted for almost 4.5 million jobs in the U.S. in 1984.
- o **AGRICULTURAL EXPORTS** accounted for one out of every four acres of U.S. farmland in production, and represented 14.7 percent of U.S. exports in 1984. The Department of Commerce estimated that agricultural exports generated employment for over 700,000 persons in 1980.
- o **SERVICES** exported generated over 2 million jobs in 1984.

U.S. exports by economic sector to all countries are shown in Chart III. Capital goods (i.e., machinery and equipment) accounted for the largest proportion (47 percent), while manufactured goods (15 percent) and agricultural products (14 percent) accounted for the next largest shares of exports in 1984.

CHART III

TOTAL U.S. EXPORTS BY TYPE
1982-1985*
($ BILLIONS)



1/ Other includes: Exports of chemicals, fuels and lubricants, and raw materials

* Estimated 1985 annualized figure based on January through June

Source: U.S. Department of Commerce, U.S. Foreign Trade Highlights, 1985

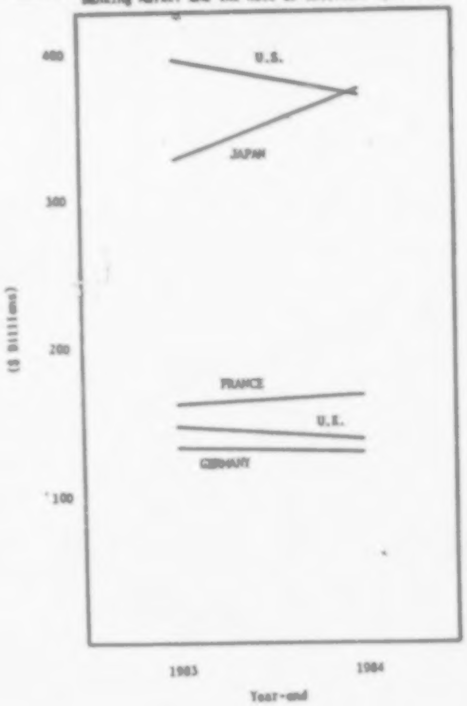
In connection with these trade statistics, it is assumed in H.R. 3838 that a reduction of U.S. banks' foreign tax credits for foreign withholding taxes will increase tax revenues by a modest amount. This assumption, we believe, is incorrect. If U.S. banks cannot competitively finance exports from the U.S., it means less U.S. exports, less U.S. production, less U.S. jobs, and less overall tax revenue. In particular, if financing becomes cheaper from foreign locations, multinationals will be encouraged to export more from jurisdictions outside the U.S., thus causing further declines in U.S. production, jobs and tax revenues.

CONCLUSION

Retention of the present foreign tax credit rules is critical to competitive U.S. bank financing of U.S. exports. Competitive trade financing is critical to the growth of U.S. exports. U.S. exports are critical to increased U.S. production and jobs. Retention of the present foreign tax credit rules is thus critical to our national economic and trade interests.

INTERNATIONAL ASSETS OF BANKS BY COUNTRY OF PARENT BANK

SOURCE: BIS, May 10, 1985, "The Nationality Structure of the International Banking Market and the Role of Interbank Operations".



DATA:
(in billions)

	1983		1984	
	Assets	Market Share	Assets	Market Share
U.S.	$303.7	20.4%	$369.5	24.4%
Japan	$326.2	21.9%	$372.1	24.6%
France	$160.0	10.8%	$167.7	11.1%
U.K.	$146.9	9.9%	$137.1	9.1%
Germany	$132.0	8.9%	$129.6	8.6%
All Other	$331.5	22.1%	$335.8	22.2%
TOTAL	$1491.1	100%	$1511.8	100%

EXHIBIT B

FOREIGN COUNTRIES IMPOSING WITHHOLDING TAXES

Developed Countries

Australia
Austria
Belgium
Canada
Denmark
Finland
France
Greece
Ireland
Italy
Japan
Luxembourg
Netherlands
New Zealand
Norway
Portugal
South Africa
Spain
Sweden
Switzerland
Turkey
United Kingdom
West Germany

Less Developed Countries

Argentina
Bolivia
Brazil
Chile
Columbia
Ecuador
Egypt
Hong Kong
India
Indonesia
Iran
Malaysia
Mexico
Morocco
Nigeria
Pakistan
Philippines
Saudi Arabia
Singapore
South Korea
Taiwan
Thailand
Tunisia
Uruguay
Venezuela

Centrally Planned Economy

China

The CHAIRMAN. Thank you, Mr. Miller.
Mr. Parracchini.

STATEMENT OF ALBERTO PARRACCHINI, PRESIDENT AND CHAIRMAN, BANCO DE PONCE; REPRESENTING THE PUERTO RICO BANKERS ASSOCIATION AND PUERTO RICO LEAGUE OF SAVINGS INSTITUTIONS

Good morning - My name is Alberto M. Paracchini and I am Chairman, President and Chief Executive Officer of Banco de Ponce, a two billion dollar Puerto Rican commercial bank. I appear before you today in my capacity as President of the Puerto Rico Bankers Association which represents the island's eighteen commercial banks. I have also been asked by Mr. Mariano J. Mier, President of the Puerto Rico League of Savings Institutions to convey to you the concerns of their twelve member institutions. On behalf of both the commercial and the thrift banking industries of Puerto Rico, I should like to express our sincere appreciation for giving us the opportunity to alert this committee regarding the adverse effects which certain provisions of "The Tax Reform Bill of 1985" (HR 3838) will produce on the financial system of our island.

Section 936 and Puerto Rico's Financial System

I should like to begin my presentation by setting forth the importance of the Internal Revenue Code's Section 936 to Puerto Rico's financial system and indeed, to our entire economy.

Section 936 of the Code, known as the Possession Tax Credit, is one of the principal economic underpinnings of Puerto Rico's economy. Enacted in 1976 as an amendment to an earlier tax sparing provision, it generally exempts from U.S. income taxes certain income of qualifying domestic corporations engaged in a trade or business within a possession ("936 corrections"). The provision also exempts the "qualified possession source investment income" of such corporations. This provision also renders taxable the investment earnings of those 936 corporations which are derived from sources outside the possessions. As a result of the 1976 amendments and in order to derive tax free qualified possession-source investment income, 936 corporations operating in Puerto Rico began returning to the island funds held overseas, primarily in the Eurodollar market. The influx of these so-called Section 936 funds alleviated the critical lack of resources being experienced by our financial system at that time and provided a needed impetus for economic growth.

In addition, the Puerto Rican government has imposed a "tollgate tax" on repatriation of income earned by these 936 corporations; however, this tollgate tax is reduced in accordance with a formula which takes into account the length of time such income has been invested within the island directly or, indirectly through the island's financial system. Thus, the longer the income is invested in Puerto Rico, the lower the tollgate tax that must be paid. Strict local rules govern the investments that can be made by banks and other financial intermediaries with Section 936 funds in order to qualify for the special tax treatment.

These Section 936 funds have grown over the years as 936 corporations have deposited accumulated operating earnings with *Puerto Rico banks and thrift institutions. Section 936 funds* currently on deposit with Puerto Rico's commercial banks amount to $6.8 billion, or 44% of the $15.4 billion in total commercial bank deposits. Section 936 funds on deposit with the island's thrift institutions amount to $1.1 billion, or 40% of the average balance of total thrift institution deposits. The availability of this low cost pool of funds is vital to the economic growth of Puerto Rico.

Let me briefly explain what the banking industry has done with the available pool of Section 936 funds. In order to qualify for exemption from taxation by the U.S. and Puerto Rico, the 936 corporations must certify to the Puerto Rico Department of the Treasury (and to the U.S. Secretary of the Treasury under proposed amendments to federal Internal Revenue Code regulations) that the funds will be invested in eligible activities. The receiving depository institution must in turn certify to the Section 936 depositor (and to the Puerto Rico Department of the Treasury) that the funds will be invested in eligible activities. Compliance with these certifications is verified by independent auditors and by the Puerto Rican government.

Current Puerto Rico law and administrative regulations provide that eligible depository institutions must invest at least 20% of their daily monthly average of eligible Section 936 deposits in obligations of the Puerto Rican government, its agencies and municipalities. As of December 1985, over $2 billion had been invested in these obligations thereby substantially improving their marketability and reducing by approximately $32 million per year the interest cost on borrowings by the island's government. These investments have greatly enhanced the support of Puerto Rico's $8.75 billion public debt, most of which is held by investors throughout the U.S. mainland.

An additional 10% of Section 936 deposits must be redeposited with the Government Development Bank for Puerto Rico. The additional funding has strengthened the financial position of that bank, which is Puerto Rico's Fiscal Agent, enabling it to obtain better terms for public sector financing, and to provide additional resources for small, promising private ventures that are otherwise unable to obtain credit from the island's financial system. In order to stimulate the construction and housing industries, current regulations also require that an additional 7% of Section 936 deposits be invested in new construction or residential loans. The balance of Section 936 funds on deposit with island depository institutions must be invested by banks in economically productive commercial, industrial, agricultural, or public purpose loans. It is important to note that all Section 936 funds must be invested within Puerto Rico in order to qualify *for the tax advantages.*

By reducing the cost of money to banks and thrift institutions on the island, the large pool of Section 936 funds on deposit has enabled these institutions to benefit consumers and business by dramatically reducing lending rates. A recently-completed Puerto Rican government study of lending practices has determined that while borrowers were paying an average of 3.46% above the prime rate in 1975, by 1985 they were only paying an average of 59% below the prime rate, a difference of over 405 basis points. This differential represents a savings to borrowers of over $112 million per year.

Section 936 deposits are characterized by their short term nature. Approximately 70% of all such deposits bear maturities of 90 days or less; only 10% have maturities of one year or longer. The reason for the short term nature of these deposits is that corporate treasurers are very much risk adverse. Uncertainty over interest rates, corporate cash needs and future changes to Section 936 compel thes corporations to keep these funds in relative liquid form so that they may be repatriated to the mainland or to anywhere else in the world with a minimum delay.

Amendments to Section 936 Proposed by HR 3838

HR 3838 includes amendments to Section 936 which would reduce Section 936 deposits with the island's depository institutions. Given the vital importance of these funds to the economic well being of the island, the Puerto Rico Bankers Association and the Puerto Rico League of Savings Institutions are particularly concerned lest those proposed amendments be enacted into law.

Subsection 841(b) of HR 3838 would increase from 65% to 75% the amount of income that must be received by a Section 936 corporation from the active conduct of a trade or business.

Accordingly, the maximum amount of qualified possession-source investment income which may be received by a 936 corporation would be correspondingly reduced from 35% to 25% in order to qualify for the tax benefits. Because exceeding the 25% limitation would result in the immediate disqualification from Section 936 status, most 936 corporations will tend not to receive more than 20% of their income from qualified possession-source investments in order to avoid involuntary disqualification. We must bear in mind that Puerto Rico's financial system is just now beginning to absorb the reduction in the qualified possession-source investment income limitation enacted barely three years ago. That amendment reduced the limitation from 50% to 35% of total gross income. The further reduction to 25% proposed by HR 3838 would effectively reduce the amount of Section 936 funds to less than one half of the pre-1982 levels.

To comply with the lower amount of possession-source investment income, corporate treasurers will be forced to make significant withdrawals from the island's depository institutions. The effect of such withdrawals could be severe as the pool of Section 936 funds deposited in Puerto Rico would be seriously reduced. In order to compensate for the loss of deposits, banks and thrift institutions would begin a costly competition to attract non-Section 936 funds. This intense competition would require financial institutions to offer much higher interest rates on their time deposits with a resulting increase in the cost of funds for all banks. Because of the structural imbalance in the maturities of their assets and liabilities, thrift institutions would not be readily able to compete for higher priced deposits.' The potential migration of thrift deposits to higher paying commercial banks would severely strain the already financially vulnerable thrift institutions, all of which are federally insured.

The higher cost of money will force banks and other lending institutions to charge much higher interest rates to their clients and consumers in general. Small business will be particularly affected, since over 90% of all loans made by local banks do not exceed $250,000. Higher borrowing costs would not be the only adverse effect of a substantial withdrawal of Section 936 funds; the reduced lending base would force bankers to substantially restrict lending practices thereby effectively shutting off small and medium size, non 936 corporations from access to affordable sources of credit. These restrictive lending practices would unavoidably lead to a further contraction of economic activity and to higher unemployment in the sector that employs the largest number of persons - small business.

Another casualty of a reduced Section 936 deposit base, would be the island's housing and construction industries. Already reeling from current economic conditions, these industries would be further affected by the proposed changes. The Puerto Rican government has established a Mortgage Trust in order to channel Section 936 funds into the housing market. More that $200 million in notes already have been issued to 936 corporations, the proceeds of which are being used to finance over 20,000 new, low cost homes. You can be sure that this and other similar worthwhile government initiatives will cease as corporate treasurers withdraw their deposits from the island's banking system.

Subsection 641(b) of HR 3838 would repeal the longstanding requirement of Subsection 936(b) that in order to be exempt from U.S. taxes, income received by a 936 corporation must be received within the possession. Repeal of Subsection 936(b) would drain approximately $300-$400 million of Section 936 deposits from island banks and thrift institutions, because 936 corporations would be permitted to receive the proceeds of their sales outside of Puerto Rico. Local banks use the float earned from Section 936 funds to blend down the interest rates charged to borrowers and as compensation for services performed on behalf of 936 corporations, such as delivering payrolls to remote plant locations. Repeal of Subsection 936(b) would also make more difficult the audit of Section 936 funds by Puerto Rico government auditors. The Secretary of the Treasury of Puerto Rico has expressed to me his concern over the proposed repeal of Section 936 (b).

Amendments to Section 861 Proposed by HR 3838

HR 3838 would make significant changes in the source of income rules of Section 861. Changes in these source of income rules would create problems for federally chartered thrift institutions in Puerto Rico which sell term notes, debentures or other capital notes to 936 corporations.

I should like to emphasize the importance which having access to the Section 936 capital market has signified for Puerto Rico's thrift institutions. Though the Puerto Rican thrift industry accounts for only twenty percent of the total resources of all depository institutions on the island, it is the source of fifty percent of all housing mortgages. Lower cost Section 936 funds have enabled thrifts to pass these savings on to Puerto Rican homeowners and to provide them with the opportunity to acquire adequate housing at more affordable interest rates. These homeowners, whose per capita income is only one half that of the lowest State of the Union, must bear a cost of living that is between ten and fifteen percent higher than that on the mainland.

As was the case with thrifts throughout our Nation during the late 1970's and early 1980's, thrifts in Puerto Rico were severely affected by the high interest rate environment and the effects of deregulation. Thrifts in Puerto Rico began to experience severe losses. Fortunately, a portion of the large pool of low-cost Section 936 funds found its way to the island's thrifts by means of repurchase agreements. By March of 1985, approximately $1.1 billion of low cost Section 936 funds had been made available through this mechanism.

In addition to receiving these funds through repurchase agreements, thrifts were able to issue longer term debt obligations secured by the Federal Home Loan Bank of New York or the Federal Savings and Loan Insurance Corporation directly to Section 936 corporations at very favorable interest rates. Since 1982 more than $700 million of lower cost, longer term financing has been provided to Puerto Rico's thrift institutions directly by Section 936 corporations. A new program of the Federal Home Loan Bank of New York guarantees deposits made by Section 936 corporations in Puerto Rican thrift institutions. More than $125 million has now been deposited under this program with terms of up to three years.

The effect of this lower cost source on funds of the operations of Puerto Rico thrifts has been remarkable. Unlike the mainland experience, Puerto Rico experienced no failures among its thrift institutions, although three institutions were acquired by healthier associations. The 1.5% to 2% differential between the cost of Section 936 funds and the average cost of funds from other traditional sources represents an additional $18 to $22 million dollars for our industry. In 1984 this differential represented the difference between a net combined profit of $16.3 million and a $5.1 million loss.

Under current law, interest paid by a U.S. corporation with less than 20 percent U.S. source gross income is treated as income from foreign sources. Subsection 612 (a) (1) of H.R. 3838 would amend this provision so that such interest paid by a domestic corporation would generally be treated as U.S. source. Since all federally chartered thrift institutions in Puerto Rico are considered U.S. domestic corporations, the proposed changes would cause the interest paid to 936 corporations on debt securities issued by such institutions to be treated as U.S. source income. The amendment to Subsection 861 (a) (1) (B) would have an additional, and no doubt unintended, negative effect on the ability of federally chartered financial institutions in Puerto Rico to attract non-deposit investments from 936 corporations. Under H.R. 3838, the source of interest on notes or debentures of such institutions would change from foreign to U.S., thus making the interest subject to U.S. tax in the hands of a 936 corporation and making it more difficult for the 936 corporation to

maintain the 80 percent Puerto Rico source income necessary to receive the benefits of Section 936. The federally chartered financial institutions in Puerto Rico, like the rest of the financially troubled thrift industry, have needed substantial infusions of long-term, non withdrawable debt capital. For such institutions in Puerto Rico, this need has been filled by investments from possessions corporations. However, the change in source rule under H.R. 3838 would make such investments extremely unattractive for 936 companies, and the resulting unavailability of this pool of capital would have seriously harmful effects on federally-chartered financial institutions in Puerto Rico. No new section 936 financings would be possible for thrift associations which would be forced to replace these funds with higher priced deposits or loan advances from the Federal Home Loan Bank. Higher cost of money would result in a lower or perhaps even a negative spread by these thrifts with the concomitant pressure on the Federal Savings and Loan Insurance Corporation.

Conclusion and Recommendations

As we have seen, the further reduction in the percentage of qualified possession-source investment income and the repeal of the current rule requiring 936 corporations to receive in Puerto Rico the proceeds of their sales, represent a potential erosion to the liquidity and lending capability of the island's banking system. The resulting withdrawals will trigger a new spiral in the cost of money thereby threatening smaller and weaker commercial banks and thrift institutions. There can be no policy justification for this result, particularly when the alleged revenue savings by the U.S. Treasury as a result of these changes amounts to only $50 million per year.

The change in the source rules would produce the unintended result of denying access by the federally chartered thrift institutions to the Section 936 capital market. The higher cost of funds may endanger the survival of weaker thrift institutions to the detriment of the federal insurance agencies.

I should like to close by again thanking your committee for the opportunity to voice our concerns regarding HR 3838's impact on Puerto Rico's commercial and thrift banking industries. If memory serves me right, this is the first time that we have been given the opportunity to articulate before this committee the particular problems affecting our local industry as a result of a major change in tax legislation. Too many times because of Puerto Rico's unique legal status, legislative changes by the Congress produce unintended adverse effects on the island. We welcome opportunities such as this to apprise our national lawmakers of our particular situation.

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The **Chairman**. Thank you, sir.

Mr. Brinckmann.

Mr. **Cassidy**. Mr. Chairman and members of the committee: at the outset, I would like to convey Mr. Brinckmann's apologies. He was taken ill with the New York flu yesterday and I believe I'm coming down with it now, so I will do my very best.

[The complete prepared statement follows:]

STATEMENT OF ROBERT CASSIDY, EXECUTIVE VICE PRESIDENT OF BAYERISCHE VEREINSBANK; REPRESENTING THE INSTITUTE OF FOREIGN BANKERS, CHAIRMAN OF TAX COMMITTEE

Mr. Chairman and members of the Committee:

On behalf of the Institute of Foreign Bankers, I would like to thank you for this opportunity to testify before the Committee on the subject of tax reform and H.R. 3838, the Tax Reform Act of 1985.

The Institute is an association comprised of more than 230 foreign banks from 55 countries doing business in the United States. Our membership includes virtually all of the foreign banks now operating in the U.S. According to June 1985 Federal Reserve Board data, foreign banks now have 333 branches and 178 agencies operating in the U.S.

As bank taxpayers, our members share the concerns that are being expressed by domestic banks on such issues as the tax loan loss reserve and the foreign tax credit. However, the issue of most immediate concern to the banks represented by the

Institute, and the issue on which they have asked me to address you today, is the so-called "second level branch tax" proposed by the House bill. At the outset, the Institute notes that due to the complexity of the branch level tax proposal, there are numerous technical issues in the House bill that must be addressed if the proposal is to be workable.

However, today I would like to address the overriding issue of whether the branch level tax should be imposed on foreign banks. For three reasons that I will discuss, the Institute believes the branch level tax should not apply to foreign banks. First, foreign banks do not abuse the current system of taxing foreign corporations. The House Ways and Means Committee Report indicates that a primary purpose of the tax is to correct "an undesirable incentive" under current law for foreign corporations to operate in branch form in the U.S., rather than through a U.S. subsidiary. The Institute submits that the decision by a foreign bank to operate in branch or subsidiary form is determined by complex business and regulatory considerations and limitations and is rarely, if ever, tax driven.

Second, the branch level tax would discriminate against foreign banks and impair our ability to compete in U.S. banking markets. According to the House Report, the tax would reduce a perceived disparity between the current tax treatment of foreign banks' U.S. branches and U.S. banks. However, the

Institute believes the branch level tax would have precisely the opposite effect, creating a significant disparity in the taxation of branches of foreign banks and U.S. banks where none now exists.

Finally, as the House Committee Report acknowledges, the branch level tax would conflict with almost all of the nondiscrimination provisions of current tax treaties to which the U.S. is a party. We question whether, in the absence of a demonstrated compelling need, Congress should enact legislation that creates potential conflicts with so many of America's treaty partners. Let me now address these issues in greater detail.

1. Background

Under current law, foreign banks are subject to Federal income tax on any income that is "effectively connected" with the conduct of their U.S. trade or business. Foreign banks are taxed on this income under rules comparable, although not identical, to those that govern U.S. banks.

Foreign banks, like other foreign persons, are also subject to a 30 percent Federal withholding tax (or lower treaty rate) on certain U.S.-source income they receive (for example, dividends and interest) that is not effectively connected with their U.S. trade or business. Moreover, under current law, if

50 percent or more of a foreign bank's income is effectively connected with its U.S. trade or business over a three-year period, a proportional part of the dividends and interest paid by the foreign bank are considered to be U.S.-source income. These dividends or interest, when paid by the foreign bank to foreign persons, are subject to a "second level withholding tax," and the foreign bank must withhold tax on these payments at a 30 percent rate (or lesser rate established by treaty).

The House bill would replace this second level withholding tax with a "second level branch tax." The second level branch tax, which would be imposed on the "dividend equivalent amount" and "allocable interest" of the foreign bank, is intended as an analogue to the withholding tax that would be owed by the bank's shareholders and creditors if the foreign bank's U.S. operations were organized as a U.S. subsidiary. However, unlike the withholding tax, the branch level tax would not be imposed on the shareholders and creditors of the foreign bank, but on the foreign bank itself.

2. The Branch Level Tax is Not Needed for Foreign Banks Because the Choice of Form of Organization of a Foreign Bank's U.S. Operations is Not Tax-Motivated

As noted earlier, the House Report indicates the branch level tax is needed to correct a perceived "undesirable incentive" for foreign corporations to operate in the U.S. in branch form, rather than through a U.S. subsidiary. This statement indicates that the House believes foreign corporations can abuse the current method of taxing foreign corporations by making a tax-driven decision to operate in branch form.

However, where foreign banks are concerned, the decision to operate in branch or subsidiary form in the U.S. is not tax-driven, but determined by complex business objectives and regulatory limitations. For example, a foreign bank wishing to enter the U.S. retail market will generally be required to use a U.S. subsidiary bank because of the need for an extensive branch network and the need for FDIC insurance. By contrast, a foreign bank entering the U.S. wholesale banking market would generally be able to compete more effectively if it established direct branches in the U.S. because, among other reasons, the branch's cost of funds in the interbank market would be lower under these circumstances and the branch's lending limits would be determined from the bank's entire capital base. Moreover, the subtle interplay between the Bank Holding Company Act and the International Banking Act often limits a foreign bank's options when entering or expanding in the U.S. banking markets.

In virtually every case, these and other business and regulatory considerations determine the form of organization that will be used by a foreign bank in a particular U.S. market. Consequently, as a practical matter there is no opportunity for foreign banks to manipulate or abuse the current system of taxation of their U.S. operations and thus no need to subject foreign banks to the branch level tax in order to prevent such abuse.

To the extent there may be abuse of the current system of taxation of foreign corporations, particularly in the context of certain treaties, the Institute would not oppose either the enactment of focused legislation or the formulation of new treaty provisions that would prevent such abuse. However, the second level branch tax will not change the form of operation foreign banks will choose for their U.S. activities, but will only impose an additional tax burden on our members who must operate in branch form.

3. A Second Level Branch Tax Would Discriminate Against Foreign Banks

The House Report indicates current law creates a disparity between taxation of foreign and domestic corporations that gives foreign corporations an "unintended advantage" over their U.S. competitors. The House believes this advantage arises because a foreign corporation's shareholders may not be subject

to U.S. tax, while a U.S. corporation's shareholders would generally be subject to Federal tax. While this argument may have some theoretical appeal, the effect of the branch level tax is, in fact, to impose a discriminatory tax on foreign banks.

As I noted earlier, the branch tax, unlike the withholding tax under current law, would be imposed on the foreign bank itself, not on its shareholders or creditors. Thus, foreign banks doing business in the United States would not only be subject to tax on their effectively connected income, but would also become subject to an additional level of Federal tax on some portion of this income. Thus, in practical effect the branch tax is a surtax which would clearly discriminate against foreign banks as compared with the U.S. banks against whom they compete.

Moreover, foreign tax credits in a foreign bank's home country will not necessarily correct this discriminatory result. Because of low home country tax rates or other limitations, many foreign banks will, in all likelihood, be unable to compensate fully for the branch level tax in their home country.

The House Report takes the position that "a branch level tax does not unfairly discriminate against foreign corporations because it treats foreign corporations and their shareholders together no worse than U.S. corporations and their shareholders." We disagree with this assessment.

The shareholders of a foreign bank, like any other foreign corporation, will continue to be subject to tax on the dividends they receive under the laws of their home country. Thus, a foreign bank and its foreign shareholders, considered as a group, could well be subject to three effective levels of tax, whereas a U.S. bank and its U.S. shareholders would be subject to only two levels of tax. More importantly, regardless of the combined tax position of a bank and its shareholders, it is clear that, from the perspective of either a foreign or domestic bank, a bank's ability to compete depends on its own earnings and after-tax profit position, not the taxes that may be imposed on its shareholders and creditors. The branch level tax, as a surtax on a foreign bank's U.S. operations, will impede our members' ability to compete in the U.S. banking markets.

4. The House Bill Would Create an Undesirable Conflict with Existing U.S. Treaty Obligations

Our final point concerns the effect of the branch level tax on current U.S. treaty obligations. As I have discussed, the second level branch tax would have a discriminatory impact on foreign banks. Indeed, the House Report acknowledges the tax would conflict with the nondiscrimination clause which, in one form or another, appears in virtually every tax treaty to which the United States is a party. We believe Congress should not enact legislation that conflicts with a U.S. treaty obligation of such broad scope without a clear showing of need.

In this regard, a particularly troublesome aspect of the House bill is the "treaty-shopping" provision, which is designed to determine, under certain circumstances, whether the branch level tax or a conflicting treaty provision will prevail. The House bill proposes an unprecedented definition of treaty-shopping that goes beyond the standard employed in most treaties, and even the standard set forth in the U.S. model treaty. The provision dispenses with any tax avoidance motive test and simply provides that treaty protection would be denied if (1) more than 50 percent of the voting shares of a foreign bank organized in a treaty country are held by persons who are not residents of that country and (2) the subsidiary bank's stock is not publicly traded. Under these circumstances, the branch level tax would be imposed, regardless of whether the bank was organized in the treaty country for valid business purposes.

This provision would, for example, deny treaty protection to a bank organized in a treaty country under certain circumstances simply because it was a wholly-owned subsidiary of a foreign bank organized in a third country. Moreover, as presently drafted, the House bill would deny protection to the subsidiary bank even if the parent bank was itself a resident of another treaty country. We see no satisfactory rationale for this drastic departure from the accepted definitions of treaty residence for treaty-shopping purposes. At a minimum, any definition of treaty-shopping should allow foreign subsidiaries to enjoy the treaty benefits of their country of residence, so long as the subsidiary is not organized for the principal purpose of obtaining such benefits.

Finally, we urge the Senate to state clearly and unequivocally that, absent treaty-shopping, the nondiscrimination clauses in current U.S. treaties will prohibit imposition of the branch tax on treaty beneficiaries. Although a close reading of the House Report indicates that the House takes this position, we believe this point needs Senate clarification and emphasis in order to avoid the risk of disrupting current U.S treaty relationships.

* * *

In sum, the Institute believes there is no need to impose a branch level tax on foreign banks. This tax would discriminate against foreign banks doing business in the United States and would adversely affect our ability to perform in the highly competitive U.S. banking markets. Moreover, the branch level

tax runs counter to the nondiscrimination provisions found in virtually all U.S. tax treaties. Consequently, the Institute urges the Committee to oppose the inclusion of this overreaching branch level tax in any tax reform bill considered by the Senate.

The **Chairman**. Thank you, Mr. Cassidy.

Senator Heinz.

Senator **Heinz**. Mr. Chairman, I want to thank you for recognizing me and I want to apologize to the witnesses both on this panel and the preceding one. I have two other hearings this morning and I'm going to have to return to the Finance Committee which, not surprisingly, is also dealing with tax reform.

I would ask unanimous consent that my opening statement appear at the appropriate point in the record.

I just want to welcome Charlie Miller from the Philadelphia National Bank. We're all very proud of that financial institution. He is here in a capacity representing the Bankers Association for Foreign Trade and I say to my other members of the committee, if all the banks that engaged in foreign lending had followed the careful practices of the Philadelphia National Bank we wouldn't have had any bankers who felt that they had gotten overextended in terms of lending loans overseas. They knew what they were doing. They were careful, and I would that everybody else had been.

OPENING STATEMENT OF SENATOR JOHN HEINZ

Mr. Chairman, today the Banking Committee is exploring the tax proposals contained in the House-passed tax reform bill as they affect financial institutions. As we examine these proposals, we must look beyond their immediate benefits to the Federal Treasury and determine if the proposals will contribute to the fairness of our Tax Code and the long-term health of our Nation.

Big banks pay little or no taxes. We hear it all the time. It would not be wise for us, however, to stop at that assertion and simply raise the taxes on banks and other financial institutions without asking the right questions.

Yesterday we heard about the problems that our country could face if the investment tax credit is eliminated and the accelerated cost recovery system is restricted. Capital formation would be reduced, industries will not be able to modernize or expand at a competitive rate and further trade deficits and unemployment could well result. Although we will gain needed revenues, we will retard our economic growth.

Today we will hear about the problems our country could face if the tax treatments of loan loss reserves, foreign taxes and tax-exempt carrying charges, among others, are changed. Although I care about the effect of these changes on our Nation's financial institutions, I also care about the effect of these changes on our trade deficit, on our cities, on our farmers and other borrowers facing foreclosures.

If we limit the amount of foreign taxes that may be credited against U.S. taxes, will we reduce the amount of money banks are willing to lend to foreign countries? If banks reduce their foreign lending, how will lesser developed countries buy our goods? Who will be hurt by this provision and to what extent?

If we disallow carrying charges for tax-exempt bonds, will banks refuse to buy them? Will cities, already hard pressed by Federal budget reductions, have to pay higher interest rates? Will our country's infrastructure fall into further disrepair?

Finally, if we change the tax deductibility of loan loss reserves, will we be encouraging banks to foreclose on borrowers who are in temporary difficulty? We have asked our banks to forebear as long as possible, to work with borrowers so they can keep their homes. The goal of keeping people in their own homes is still important to me and I want to ensure that tampering with the Tax Code does not work against the goal.

Today's hearings provide us with the opportunity to learn the full effects of the House-passed tax reform provisions that touch on our financial institutions. I hope that our witnesses have facts and figures to support their arguments that the revenue raised by these proposals will be offset by the revenue and other losses that result from these changes.

Senator SASSER. Would the Senator yield for just a moment? Mr. Chairman, I have some questions which I would like to submit for the record.

Senator HEINZ. That's really all I wanted to say, Senator Sasser, and I just wanted to welcome Mr. Miller. I see Tom Farmer behind him, who is with him, and I just want to say, Charlie, I appreciate you being here.

Mr. MILLER. Thank you. It's a pleasure.

The CHAIRMAN. Thank you, Senator Heinz.

Senator Cranston.

Senator CRANSTON. Thank you very much. I do not have any questions at this stage.

The CHAIRMAN. You mentioned the provision in H.R. 3838 quite extensively that eliminates the second level withholding taxes of the current law and replaces them with the branch level tax on income of foreign corporations. The rationale that I heard from the House on this was that almost all foreign corporations with U.S. branches avoid liability for second level withholding taxes by keeping their U.S. income below the 50-percent threshold, and that therefore, because they are able to manipulate their reported earnings to do that, current law provides an incentive for foreign corporations to operate in a branch form.

Do most branches of foreign corporations avoid paying second level withholding taxes by staying beneath that trigger?

Mr. CASSIDY. I don't believe that's a practical response because when you consider that a branch is part of a whole, and when you compare the size of the bank to the size of its branch it would be very difficult for me to imagine how they could earn more than 50 percent of the entire banks worldwide income. You must also remember that the banks that we are referring to are very large and in most cases the creme de la creme of their countries. It's always well below 50 percent. The branch would not have the earning power that a bank as a whole would have and the majority of the earnings assets of any foreign bank clearly would be outside the United States.

The CHAIRMAN. So you think it's possible that it is not a practical application of the law?

Mr. CASSIDY. It's not practical.

The CHAIRMAN. Mr. Miller, one of the criticisms of the current foreign tax credit is that loans are made in foreign countries—and I asked the first panel, this too—that would otherwise really not be supportable except for having the tax credit. Would you comment on that?

Mr. MILLER. I was very interested in hearing the question and glad that you've asked it again. Banks do not make loans in consideration of profitability if they don't think that they're good loans. There is no way to make a marginal loan better by pricing. Pricing is a consideration with respect to the financial return we require on our assets and our equity. And if the credit is acceptable, then how acceptable is it to the bank.

NO ECONOMIC BENEFIT ASSOCIATED WITH WITHHOLDING TAX

There has been a lot of discussion about economic benefits associated with withholding tax. There is no economic benefit associated with withholding tax. It is a legal liability of our bank to pay the tax.

In the example that I gave on the Australian sale, without the ability to use the tax credit, we would be under water and we would not do the deal.

So to answer the question more specifically, no, it is not a motivation with respect to making foreign loans in areas in which we would normally not want to make loans.

The CHAIRMAN. Well, with all of the problems we have with our foreign lending, I wish more of your competitors had followed that philosophy. We wouldn't be quite so worried about all of the outstanding foreign loans because in looking at them now, they certainly weren't made—many of them—on the basis of the credit risks but instead on pricing and politics and a lot of other factors rather than the good judgment on what a risk should be. So Senator Heinz' comments about your situation apparently are accurate. I appreciate your answer.

Mr. MILLER. Many of the regional and money center banks alike have problem loans abroad and it's always easy to in hindsight to have 20-20 vision. I guess we happen to be in the type of business where we key our financing to specific products, to specific customers. Trade finance is all about transaction financing.

We feel that is sound banking practice and I think most money center banks and regionals do alike. We just happen to have gotten ourselves into a situation which is difficult now to work ourselves out of as an industry.

The CHAIRMAN. Gentlemen, thank you very much. We appreciate your testimony.

We have one final panel to appear before the committee today composed of Mr. Joseph C. Morris, president, Columbia Savings Association, Emporia, KS; and vice chairman, U.S. League of Savings Institutions; and Mr. Kenneth Albers, chairman, Provident Savings Bank, Jersey City, NJ; and chairman, National Council of Savings Institutions.

Mr. Morris, if you would like to begin, please.

STATEMENT OF JOSEPH C. MORRIS, PRESIDENT, COLUMBIA SAVINGS ASSOCIATION, EMPORIA, KS; VICE CHAIRMAN, U.S. LEAGUE OF SAVINGS INSTITUTIONS

Mr. MORRIS. My name is Joe C. Morris. I am president of Columbia Savings Association of Emporia, KS, and I appear today on behalf of the U.S. League of Savings Institutions.

We welcome this opportunity to discuss with you the comprehensive tax legislation now pending before the Senate. The administration's recommendations of last May were modified in several major respects by the House of Representatives in H.R. 3838.

EFFECTS OF H.R. 3838 ON HOUSING FINANCING

The original proposal sent to the Hill and the legislation adopted by the House pose severe problems for savings institutions, the agencies responsible for their supervision, and for our customers. Unless modifications are accomplished by the Senate and adopted by the Congress, the ability of our institutions to provide thrift and home ownership will be seriously impaired. The Federal Deposit Insurance funds will encounter new handicaps in their ongoing efforts to resolve supervisory problems.

The tax treatment of savings institutions is a complex and technical area.

In this oral statement I will try to summarize briefly and simplify the major problem areas from our industry's point of view.

First of all, let me say that savings institutions are significant corporate taxpayers when operating profitably. Under current law, our effective tax rate is over 31 percent—very close to the 33-percent rate advocated for corporations generally by President Reagan.

Our basic Tax Code incentive for housing finance is section 593, the authority to deduct for reserves allocated for bad debts. The original rationale for bad debt reserves was to provide a tax offset for the risks associated with long-term home finance. The wisdom of that approach is never more apparent than it is today.

The administration wanted to repeal this deduction entirely and to recapture a portion of past allocations into taxable income over 10 years—a future tax liability of $1.5 to $2 billion, depending upon calculation details—which were never revealed. More importantly, however, our accountants were unanimous in saying that a tax liability reserve for the entire $2 billion would have to be reflected immediately on financial statements. That would have meant an immediate $2 billion hit to the already depleted net worth position of our industry.

The House did not accept the complete repeal of section 593. It preserved a thrift bad debt reserve for the future but at a much reduced level of 5 percent. By continuing the reserve, there is no justification for recapturing past allocations and the resulting depletion of industry net worth. The language also simplifies the qualifying assets test for eligibility to use section 593 and removes section 593 as a tax preference subject to the percentage reductions required for preference items under section 291.

We strongly urge the Senate to ratify without change the 5-percent thrift bad debt reserve approach of H.R. 3838. Under this approach thrifts will contribute $750 million or more in additional revenues over the next 5 years.

There are, however, two problems created by the House in this area. The first was the last-minute increase in the corporate rate to 36 percent. Thus, even with section 593 preserved, the effective tax rate for thrifts goes up to 34 percent. We support the corporate community's efforts to move back to the 33-percent rate advocated by the President. Second, the general rate reductions are timed to occur on July 1 while the scaledown of our thrift bad debt reserve took place on January 1. These discrepancies in effective date would create a 1-year spike to 39 percent in our industry's tax rate.

NO RELIEF FOR ACCUMULATED NET OPERATING LOSSES

Another major shortcoming in the House-passed bill is the failure to provide transition relief for accumulated, but soon to expire, net operating losses.

This committee is very familiar with the massive losses incurred in 1981 and 1982 in the thrift industry. Present law permits carryforward of only 5 years. The President proposed, and the House adopted, a 15-year carryforward, but only for new losses after New Year's Day of this year. The problem of expiring NOL is particularly acute in regions of the country where the return to profitability has been painfully slow.

The Congress has established a procedure which may help solve this problem. When the 1981 tax law extended carryforwards for corporations generally a transition was provided permitting use of expiring losses incurred 5 years earlier. All segments of the thrift industry advocate a parallel transition which would enable thrifts to carry forward for 8 years losses incurred between 1981 and 1985. Failure to grant this relief will seriously retard the return to health and the rebuilding of net worth for many institutions, not to mention further difficulties for the FDIC and FSLIC. Price-Waterhouse has estimated a maximum revenue sacrifice over 5 years at $300 million for this transition relief.

In another area, at the Treasury's insistence, H.R. 3838 mandates the use of accrual-basis, rather than cash-basis, tax accounting by financial institutions. Price-Waterhouse estimates a $1.2 billion increase to our tax bill over 6 years with an accompanying negative impact on our reserve for losses. This simply doesn't make sense for financial intermediaries which serve retail cash-basis depositors and cash-basis borrowers—and we think should be eliminated in the Senate.

There are several changes in H.R. 3838 which will make virtually impossible the resolution of problem cases at the FSLIC. The House bill would repeal as of last month special code provisions that exclude FSLIC assistance payments from income and from qualifying a supervisory acquisition as a tax-free reorganization. The tax writers in the House claimed a $1.6 billion revenue gain from repeal of these provisions, but the costs to the Government's deposit insurance fund could be many times that amount if problem cases cannot be resolved.

Not only should repeal be deferred, as advocated by the President, but these Tax Code incentives to the least-cost resolution of problem cases are needed as well by the FDIC.

But simply preserving the special FSLIC premiums is not enough because matters are made worse by the House language regarding the general corporate limitations on transfer of losses in mergers and acquisitions. This discourages one of the major means for infusing new capital into the thrift industry. As a matter of fact, there's an article in the Wall Street Journal this morning that indicates that the Bank Board is seriously considering increasing the capital requirements of the thrift business, which certainly we support, but the House language would be a severe detriment to increasing capital in the industry through conversions to stock associations.

Finally I should mention a new problem created for the marketing of IRA accounts by our institutions. The House bill links the permitted annual contributions to an IRA account with those permitted for the popular 401(k) plans. When a wage earner has both retirement savings devices, he or she sacrifices a dollar of contribution for the IRA account for each dollar contributed to the 401(k) plan. The overall result is to discourage use of IRA plans and retirement savings programs—in direct contrast to the capital formation goals which ought to guide our tax policies.

Our league is also concerned about the threat to the deductibility of State and local property and income taxes. And, as you have no doubt heard from other housing-sector witnesses, the House-passed bill creates major problems for real estate investors—problems we share when we acquire real estate owned through default on loans.

I have appreciated your attention to these vital issues raised by the comprehensive tax legislation awaiting consideration in the Senate and look forward to your questions.

[The complete prepared statement follows:]

Statement of

JOE C. MORRIS

President, Columbia Savings Association, F.A.

Emporia, Kansas

in behalf of the

U.S. LEAGUE OF SAVINGS INSTITUTIONS

Thank you, Mr. Chairman, and members of this distinguished committee. My name is Joe C. Morris and I am President and Chief Executive Officer of Columbia Savings Association, F.A., of Emporia, Kansas. I appreciate this opportunity to appear before you today in my capacity as Chairman of the Committee on Corporate Taxation of the U.S. League of Savings Institutions.*

The U.S. League and its savings institution members are profoundly affected by the tax reform proposals adopted as part of the House Tax Reform Act of 1985 (H.R. 3838). From the way our institutions have been taxed for the last 23 years, to our accounting treatment, to our utilization of net operating losses and finally in our ability to compete for the stable, long-term savings dollar, this recently-passed House tax reform measure will fundamentally impacted our savings institution members.

As the major supplier of home mortgage credit to the nation, we are particularly concerned with the tax reform's potential impact on housing activity. It is by no means clear that the indirect benefits the package will bring in such as lower interest rates (from the projected increased savings flows at lower individual tax rates) will be enough to offset the direct burdens on homeownership costs. In addition, the adverse impact of certain provisions of the reform proposals would severely limit the ability of our specialized institutions to continue to provide mortgage finance, and thus further increase the costs of homeownership.

Measuring the particular economic impact of the tax code changes is difficult even for individual items, but for such a broad range of simultaneous tax code revisions the difficulty is greatly compounded and resulting economic projects are less reliable. Our savings institutions have recently survived a prolonged period of high interest rates, deregulation of liabilities before assets, and increased competition for savings, which forced over 900 of our members to be merged, acquired, or liquidated.

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*The U.S. League of Savings Institutions serves the more than 3,500 member institutions which make up the $1.1 trillion savings association and savings bank businesses. League membership includes all types of institutions -- federal- and state-chartered, stock and mutual. The principal officers include: Gerald J. Levy, Chairman, Milwaukee, Wisconsin; Joe C. Morris, Emporia, Kansas; William B. O'Connell, President, Chicago, Illinois; Philip Gasteyer, Executive Vice President and Director of Washington Operations; and James O. Freeman, Senior Legislative Representative. League headquarters are at 111 East Wacker Drive, Chicago, Illinois 60601. The Washington office is located at 1709 New York Avenue, N.W., Washington, D.C. 20006. Telephone: (202)637-8900.

We, therefore, urge Congress and the Administration to proceed with caution, examining where possible both the macroeconomic and sectoral impact of the House-passed plan in order to avoid potentially harmful and unforeseen damage to our underlying economic structure.

THRIFTS AS CORPORATE TAXPAYERS - A HISTORICAL PERSPECTIVE

The President's recommendations would totally restructure the tax treatment of savings institutions as corporate taxpayers. The core provision of savings institution taxation under present law is a special provision allowing a percentage of taxable income to be set aside as a bad debt reserve: almost all other unique aspects of savings institution tax flow from this one item. The repeal of this Section 593 special deduction would thus essentially eliminate the distinctive tax treatment accorded savings institutions by Congress for the last 23 years.

A brief look back into the history of financial institution taxation shows that as long ago as 1921 commercial banks were provided a reserve deduction for debts which become worthless during the year in addition to an allowance for future bad debt exposure. This reserve for bad debts helped commercial banks reduce their current tax liability. Savings institutions by contrast, remained exempt from federal taxation until 1951 when tax liability was imposed on income exceeding 12 percent of an institutions' savings balances. Then in the Revenue Act of 1962, savings institutions, like commercial banks, became subject to regular federal corporate tax except for the option of the special thrift percentage-of-taxable-income bad debt deduction (Sec. 593(b)(2)). Congress, in granting this deduction, recognized the substantial risks involved with long-term real estate lending and the importance of credit to finance homeownership.

This benefit was also to encourage savings institutions to remain specialized housing originators and investors. Thrifts received the maximum tax benefits of Section 593 when 90% (pre-1969) of their assets were in certain housing credit-related and necessary liquidity "qualifying assets." Today (post-1969), 82% of savings and loan and stockholder-owned savings bank investments must be in cash, government and municipal obligations, real property loans, or other housing-related investments in order to receive maximum benefits from the bad debt percentage-of-income deduction. (Mutual savings banks receive maximum use of the percentage-of-taxable-income method when 72% of their investments are enumerated qualifying assets.) These housing-investment restrictions are the "pri[illegible] thrifts must continue to pay to enjoy the maximum tax benefits of Section 593. The special thrift bad debt deduction is denied to all thrifts, mutual and stock, savings and loan association or savings bank, if less than 60% of their assets are in qualifying loans.

In 1969, Congress granted full use of the special thrift bad debt deduction to savings banks with a 72% qualifying assets ratio -- in recognition of historical differences between savings and loan associations and mutual savings banks. Also that year, savings and loans and mutual savings banks were also allowed to compute their deduction for bad debts using either of the commercial bank methods (experience or percentage of eligible loans). In the intervening years, the two types of institutions have become virtually indistinguishable, particularly with the passage of the Garn-St Germain Depository Institutions Act of 1982, which encouraged new investment flexibility to assure continued institutional viability. In the event that there is no overall tax reform legislation passed in this Congress, we would recommend as a stand alone provision that all savings institutions be allowed full use of the bad debt deduction at the 72% level. The key role of thrifts in home finance can be expected to continue on the grounds of management expertise alone, absent any radical downgrading of homeownership benefits in the individual income tax structure.

The record of savings institution commitment to housing is well established. Today the $1 trillion savings and loan business and the $300 million savings bank industry hold more than 50% of private residential mortgage debt and 40% of all mortgages nationwide. Thrifts have fulfilled congressional intent by serving as a primary source of credit for home buyers and sellers well beyond the expectations which prompted the changes made in the Revenue Act of 1962. Their housing specialization -- mandated, in part, through our federal tax code, has not, however, come without cost. Thrifts continue to face the peculiar risks of long-term home financing specialists -- incurring, in particular, significant operational losses from the inherited mismatch of short-term deposit costs and long-term investment returns during the recent high interest-rate period.

The Ways and Means Committee report accompanying the Revenue Act of 1962 clearly indicates that the special bad debt reserve approach was to provide "reserves consistent with the proper protection of the institution and its depositories in light of the peculiar risks of long-term lending on residential real estate." Congressman Keogh referred to the peculiar risks associated with long-term real estate lending in a March 28, 1962 floor speech advocating the new percentage-of-taxable-income reserve method. Keogh stated that a thrift institution:

> "----is a different kind of organization from a commercial bank----the matter of investment losses is quite different between the two types of organizations. Home mortgage investments are long-term investments with different risk characteristics than short-term commercial paper. It was clear to the Committee on Ways and Means that loss reserve provisions applicable to loss experience on commercial paper have no relevance to an appropriate reserve on long-term real estate loans.
>
> Actually there is no certain formula that will tell us what is the exactly appropriate loss reserve for long-term real estate loans. The very uncertainty of these losses is the problem."

Congress was extremely prescient in making provision for unforeseeable, extraordinary losses in the mandated home financing specialization. It is true that the losses ultimately arose from the interest rate risk built into the mortgage portfolio rather than default risk, but the reserve accumulation permitted under the tax code was vital in weathering the storms of the last few years.

We emphasize that these tax favored reserves are not available for distribution to stockholders, but must be retained to cover the losses against which they are provided. Indeed, without the percentage reserve method granted our institutions in 1962 the thrift business would have been hurt even more by the devastating losses of 1981 and 1982.

The 1969 Tax Act was the last major revision of financial institution taxation. In the 1969 Act the allowable thrift percentage bad debt allocation was reduced over 10 years from 60% to 40% of taxable income. At the same time this phase-down of the bad debt reserve deduction was enacted, Congress attempted to reduce any negative impact of this change by granting financial institutions special net operating loss (NOL) treatment of 10 years carryback and 5 years carryforward in order to "provide an extra margin of safety to protect against the possibility of unusually large bad debt losses." (Report of the House Committee on Ways and Means to accompany HR. 13270, the Tax Reform Act of 1969). Since 1969 additional tax changes have been enacted which have altered the tax status of thrifts. The 1981 Economic Recovery and Tax Act provided greater net operating loss carryforward treatment (15 years) for ordinary corporations. Despite this significant enhancement of the regular corporate carryover period, financial institutions were held to their pre-1981 5-year carryforward level. The 1981 Act also required stock-form savings banks to maintain the higher savings and loan level of qualified investments (82%) in order to receive the maximum bad debt percentage deduction. In 1982 the Tax Equity and Fiscal Responsibility Act, and then in 1984 the Deficit Reduction Act combined to cut back by 20 percent the amount by which the bad debt reserve deduction (Sec. 593) exceeds the amount which would have been allowable on the basis of actual experience. This new corporate tax preference Section (Sec. 291) of the code -- which disallows a portion of preference items -- has further undermined the tax treatment originally intended by Congress for the thrift industry.

THRIFT TAX BURDEN INCREASES

The U.S. League believes that all corporations enjoying the fruits of our economic system have a continuing obligation to contribute adequate tax revenues to meet the expenditure needs of the nation. The thrift business is one industry which continues to meet its tax-paying responsibility in this regard.

In spite of the benefit of Section 593, thrifts have been paying an increasing amount of federal income tax beginning with the Revenue Act of 1962. As outlined above, this level was increased by the Tax Reform Act of 1969. The following Table I depicts the higher statutory thrift tax rate from the 1969 bad debt reduction, as well as the increased tax liability resulting from the preference cutbacks in the 1982 and 1984 Tax Acts.

TABLE I

Taxable Year Beginning	BDD-Percentage of Taxable Income Method	Statutory Tax Rate
1969	60%	19.2%
1970	57%	24.28%
1971	54%	25.27%
1972	51%	26.27%
1973	49%	26.93%
1974	47%	27.60%
1975	45%	28.26%
1976	43%	28.92%
1977	42%	29.26%
1978	41%	30.22%
1979	40%	29.46%
1980	40%	29.46%
1981	40%	29.46%
1982	40%	29.46%
1983	34%	30.36%
1984	34%	30.36%
1985	32%	31.23%

Unlike money-center commercial banks which have used a variety of tax management techniques to reduce their U.S. tax liability on worldwide and U.S.-derived income to extremely low levels, profitable thrifts face effective federal tax rates in the 30% range. Table 2 depicts the actual federal taxes paid by thrifts over the 1970s. (The table stops at 1979 since beginning in 1980 many institutions sustained losses, and virtually the entire industry became unprofitable in 1981 and 1982; thus the percentage-of-taxable income method has been little utilized by thrifts in this decade.) In tax year 1985, however, the business showed the best earnings performance since the late 1970s and will happily return to positive tax-paying status.

TABLE 2

Taxable Year	Pre-Tax Book Income	After-Tax Book Income	Book Federal Tax Expense	Federal Taxes Paid
		($ millions)		
1970	$1,165	$ 925	$ 216	$ 186
1971	1,748	1,313	359	314
1972	2,317	1,687	517	457
1973	2,655	1,897	621	541
1974	2,143	1,482	532	468
1975	2,082	1,448	500	406
1976	3,218	2,249	775	628
1977	4,610	3,198	1,151	1,018
1978	5,716	3,918	1,435	1,275
1979	5,197	3,619	1,307	1,091

Source: U.S. League of Savings Institutions, Federal Home Loan Bank Board data cross-checked with Corporation Income Tax Returns (Treasury Department) for the various years.

Note that the combination of financial and tax return data produces a different value for the effective tax rate, the proportion of income taken by taxes, than the computation from the taxable income base. No single measure of tax burden is completely satisfactory. This method gives the lowest figure for corporate tax liability.

RESERVE ACCOUNTING AND THRIFT PORTFOLIO RESTRICTIONS

The Administration's proposal to eliminate Section 593 would reverse 23 years of tax and housing policy.

Today savings institutions, because of their portfolio specialization, do not utilize tax incentives enjoyed by other depository institutions and consequently the 33% rate proposed by the Administration closely approximates current thrift marginal tax rates. In addition to repealing the special thrift bad debt reserve method the Administration plan would also abolish the reserve method of accounting for bad debts. In its place a system of specific charge-off would replace the traditional and well-understood reserve methodologies. Most corporations today utilize a six-year moving average of bad debt experience, a method also available to thrifts and commercial banks. Commercial banks also use a second option percentage-of-eligible-loans bad debt addition. Thrifts on the other hand utilize either commercial bank method (the moving average experience or the commercial bank eligible-loan formula) or their special thrift percentage-of-income method.

The Treasury argues that any reserve method of accounting for bad debts overstates the true size of bad debt losses and that the charge-off system, delaying any deduction for such bad debts until actual write-off, is preferable theoretically and more accurate practically. We do not accept such a contention. Though there may be some legitimate debate over "excessive" deductions from certain hitherto permissible bad debt methodologies, such debate is a separate issue from the question of the validity of reserve accounting. In fact, such reserve accounting is clearly better matched on theoretical grounds to the accrual basis of accounting which the Treasury advocates elsewhere in its reform package and which we shall address later in this statement.

The U.S. League strongly urges the retention of some method of reserve accounting for bad debts, at least for financial intermediary bad debt exposure. For most corporations not engaged in the business of lending funds, except perhaps in the form of trade credit, bad debt losses are probably a minor and incidental expense. For financial intermediaries, bad debt reserves are an integral part of their basic business and deserve more analysis than offered in the Treasury package.

Specific charge-off as a substitute for reserve accounting is totally unsatisfactory especially for mortgage loans. The method fails to take into account the timing of the lender's economic loss from bad debts. These economic losses occur much earlier than the point at which a loan can be formally written off for tax purposes. The write-off for a bad loan is usually the last step in a drawn-out process which starts when a loan becomes troubled, continues through a work-out, foreclosure or redemption period, and culminates only when a loan is either finally collected or written off.

Specific charge-off postpones the tax recognition of any loan loss expense until after this expense has been incurred economically, whereas reserve accounting more accurately measures economic income.

PROPOSED RECAPTURE OF BAD DEBT DEDUCTIONS

In addition to the theoretical shortcomings of the proposal to eliminate the reserve method of accounting for financial institution bad debts, this flawed element of the Administration package brought with it a host of ancillary complications. The proposal is intimately linked to the requirement to "recapture" the tax benefits from past bad debt deductions.

Henceforth, when assets go bad, the loss would be charged directly to taxable income rather than to a tax reserve dating back to the original investment period. (If accumulated bad debt reserves are not recaptured, taxpayers would, in effect, get a double deduction -- once, at the time of the initial addition to the reserve, and, second, in the future when the loss is directly charged on the tax return rather than to the reserve.) Consequently, under the Administration's plan, accumulated bad debt reserves would be recaptured so that every taxpayer's return will retroactively be revised "as if" this new system had always been in effect.

For savings institutions, the impact of the recapture proposal is peculiarly adverse. The burden of actually having to pay the tax may be the lesser of the associated problems for savings institutions. The special bad debt reserves accorded thrifts since 1962 were in return for their concentration on residential finance. That concentration, in an era of deposit rate deregulation, combined with historically high interest rates, proved exceptionally costly to many institutions. The Administration partially recognizes that connection and has not proposed a recapture of all the benefits of the special thrift bad debt deduction but only of that part equivalent to what could have been claimed had the thrift bad debt method never been enacted.

The portion to be recaptured under the Administration plan would be the greater of the commercial bank method (Section 585) and the actual loss experience. (Treasury officials have yet to declare the precise calculation of the equivalent "commercial bank reserve" to be recaptured.) Furthermore, this amount could be taken into income by the thrift either in the first year or over 10 years. Though this partial recapture approach appears to be "fair", it hardly leaves an institution in the flexible investment portfolio position of a commercial bank. Not only would the President's plan eliminate all special tax incentives for thrifts to continue to focus their investment in housing, but even in its revised form, recapture would still retroactively penalize institutions.

An independent study by Price Waterhouse on the impact of the various tax changes advocated by the Administration (and H.R. 3838) on the thrift business establishes that recapture will cost the industry $1.3 billion in additional taxes over 5 years. The financial statement impact of this added tax liability cannot be deferred, however, and would be required to be recognized immediately as explained below.

In its consideration of how to reflect the tax savings for an institution from the use of the thrift bad debt reserve method, the accounting profession accorded that benefit the status of a permanent difference between book and tax return income. The provision enacted in 1962 and adjusted in 1969 was not scheduled for phase-out, as was the case for the commercial bank method and no mention of recapture was ever made.

Consequently, the thrift tax savings flowed through the income statement into the net worth accounts of the business, quite unlike the situation at commercial banks, where the tax saving was transferred to a deferred tax liability account. Commercial banks will face the cash flow burden of actually paying the recapture tax. Savings institutions would first have to reflect a new tax liability on their books far in advance of the actual payment of the tax.

At the moment and by coincidence, the entire financial accounting methodology of reflecting the impact of changing tax laws and rates on financial statements is in flux. Because of the uncertainties in the relative timing of the tax law and accounting principles no definitive answer on the magnitude of financial statement impact can be given. However, it appears in all likelihood that savings institutions will encounter a uniquely severe impact from the recapture of bad debt reserves as recommended by the Administration.

The Financial Accounting Standards Board (FASB) is expected to require immediate creation of a deferred tax liability on thrift financial statements. So while the tax impact can be spread over 10 years, the financial statement impact from recapture could be immediate, wiping out at one stroke a good deal of the net worth of the thrift industry.

Following the massive erosion of net worth in our industry in 1981 and 1982 and the slow return to profitability thereafter, this threat to thrift sector recapitalization by reserve recapture will be sorely felt by both the housing sector and the federal agencies responsible for insuring depositors against institutional failure. The adverse impact of recapture on the fragile condition of thrift financial statements far outweighs the minimal revenue pick-up. Even the need for revenue neutrality in developing a tax reform proposal, does not justify such a retroactive, inequitable result.

PRESERVING SOME RESERVE FOR THRIFT INSTITUTIONS

The entire question of reserve method accounting for thrifts should be carefully studied by Congress. The existing system was enacted in recognition of the portfolio restrictions characteristic of both federal and state-chartered thrift institutions in 1969. Clearly, some liberalization of asset authorities has been achieved at both federal and state levels in the intervening quarter-century -- but that liberalization has been accompanied, indeed preceded, by total deregulation of savings deposit interest rates. So far, the outcome of the deregulation process has been to weaken, rather than strengthen, institutions -- though, at this point, the future looks far more promising.

Substantial investment restrictions still apply to the thrift industry and Congress should be aware of this fact. The Administration's tax proposals advocate a uniform tax treatment for financial institutions thereby implicitly assuming that full investment authority has already been granted to thrifts or will be shortly but that is not the case. The Banking Committees in each House of Congress have reviewed legislation in recent years which maintain a number of significant constraints on investments by federally-chartered thrifts and, for the first time, impose federal limits on the exercise of state-charter empowerments. Though the outcome of this legislative effort cannot be predicted and since some restriction on unfettered use of state powers is likely to protect the Federal Savings and Loan Insurance Corporation it seems certain that major restrictions or limitations on thrift investment authority will continue. Therefore, the U.S. League urges the Senate Banking Committee to assist our effort to retain some special tax incentive for our continued specialization in home finance.

The House-passed Tax Reform Act of 1985 resolved this problem from the thrift industry's perspective. The House Bill (H.R. 3838) recognized the importance of continuing the incentive for housing investment contained in the thrift bad debt deduction at a lowered 5 percent level. By reducing rather than eliminating the percentage of taxable income method for thrifts, the House avoided thrift recapture, adopted a simplified qualified asset test for the bad debt deduction (60 percent) and continued the tax incentive for thrifts to originate a significant percentage of mortgage-related assets without creating a significant competitive advantage over other financial institutions.

Retention of the reserve method of accounting for thrift bad debts even at the 5 percent level eliminates the need for retroactive recapture linked to specific charge-off, narrows the gap between experience-level losses and thrift bad debt deductions, and provides a mechanism whereby the fragile thrift sector can be insulated from any subsequent increases in the corporate tax rate. The size of the corporate rate reduction is essential in making an accurate determination of how large the reserve deduction needs to be to avoid unmanageable thrift tax increases. This problem occurred with the House-passed tax bill when the bad debt reserve was fixed at 5 percent on the basis of a 33% corporate rate and then that corporate rate was increased during committee negotiations to 36 percent.

Additionally, the House Bill delayed the corporate rate reduction to July 1 while repealing most preferences 6 months earlier on January 1. This higher corporate rate (33%

vs 36%) and the delay in its effective date will seriously jeopardize the savings business and its ability to fulfill its role as the nation's primary source of home mortgage credit, particularly in tax year 1986 when a blended corporate rate of approximately 39 percent would apply to our institutions. Therefore, if Congress decides to phase down or delay the regular corporate rate reduction from 46% to 33% rather than make the switch immediately, the Section 593 benefit should also have to be phased down proportionately to avoid a sudden acceleration of thrift industry net worth erosion.

Without the net worth accumulated under the bad debt reserve method, the thrift business probably would not have survived the devastating losses of 1981 and 1982. The reserve method protected the safety and soundness of thrifts in the face of those enormous and unforeseeable interest rate loses. Today the thrift industry remains in a fragile condition and its recovery must be maintained to ensure the future health of housing finance and to protect the federal agencies which insure depositors against institutional failure. Continuing the thrift bad debt reserve is an essential step in this recovery process.

The U.S. League, therefore, opposes the imposition of the bad debt charge-off method as put forth by the Administration and recommends making a fresh start with a 5 percent taxable income reserve (as in H.R. 3838), but without the delay in corporate-rate reduction contained in the final version of the House-passed bill. A number of technical issues arise in this area relating to the restrictions on grandfathered reserves. These questions revolve around Section 593(e) and we would be happy to discuss them with Committee staff.

PRESERVING EXISTING NET OPERATING LOSSES

Financial institutions have operated since 1969 using a net operating loss treatment of 10 years carryback and 5 years carryforward. At the time, this was a more generous departure from the general corporate rule of 3 years carryback and 5 years carryforward.

Subsequent changes in tax law and regulation have reserved that favored position for savings institutions. In 1979, the Treasury, without any legislative prompting, adopted a new regulation whereby the tax refund benefit of an NOL carryback was cut in half. Under that regulation, institutions were required to reduce the allowable special thrift bad debt deduction by an amount proportional to the amount of the NOL carried back to that previous positive tax payment year. The effect is to increase the tax liability of the institution and reduce the refund. This change was made, by coincidence, exactly at the time when widespread operating losses began to threaten the business. Its impact on tax recoveries has been severe. Citing the need to "provide an extra margin of safety to protect against the possibility of unusually large bad debt losses," Congress had provided the benefit of a longer carryback for net operating losses to offset reductions to the thrift bad debt reserve contained in the same 1969 Tax Act.

Shortly after this IRS regulation, the Economic Recovery and Tax Act of 1981 (ERTA) left the NOL rules for financial institutions unchanged at a time when nonfinancial corporations were granted a more favorable 15-year carryforward authority. This new rule, plus the existing 3-year carryback, provided nonfinancial corporations with a greater 18-year net operating loss aggregate carryover period than the combined 15-year treatment (10 back, 5 forward) afforded financial institutions. Moreover, ERTA also allowed nonfinancial corporations to use the new carryforward period against losses incurred in 1976 and subsequent years, not just those incurred after 1981.

The loss of the favorable combined carryover period occurred at a time when such benefits would have been most beneficial. The losses incurred by savings institutions from historically high interest rates in the early 1980s clearly fall into the category of unique risks contemplated by Congress at the time special rules were originally granted.

The Administration's 1985 tax reform recommendations proposed applying *prospectively* the general corporate carryforward rules to thrifts. This denial of extended NOL carryover treatment for *existing* losses runs counter to the clear precedent established in 1981 under ERTA, as well as violating the congressional intent of the 1969 Tax Reform Act granting financial institutions a superior NOL treatment in recognition of the special safety and soundness concerns which are unique to depositories.

The general rationale for net operating loss carryback and carryforward is that a taxpayer should be able to average income and losses from a trade or business over a period of years to reduce disparities from fluctuating incomes. This rationale is particularly appropriate for thrifts whose long-term investment portfolios make their net income particularly vulnerable to sudden increases in interest rates. For financial intermediaries, the bottom line is the difference between relatively huge gross interest income and interest expense totals. Relatively minor savings in interest rate levels can produce huge changes in net earnings.

Full carryforward opportunity for net operating losses is especially important for institutions which have assisted the federal insurance agencies (FSLIC and FDIC) by participating in supervisory mergers -- acquiring troubled institutions operating at substantial losses. Denial of equitable tax loss carryforward opportunities will further complicate the task of the FSLIC and FDIC in attracting future merger partners.

The interest rate losses from deregulation in the early 1980s have dramatically increased the number of problem thrifts for which the FDIC and FSLIC insurance funds are responsible. In addition the unprecedented volatility of interest rates through the period of liability deregulation produced huge fluctuations in thrift bottom line performance and therefore an extended NOL carryforward period as a transition mechanism is wholly appropriate.

The U.S. League, therefore, recommends granting any thrift institution [defined in Secs. 593(a) and 591(b)] with net operating losses incurred in tax years beginning on or after January 1, 1981 and ending by Dec. 31, 1985 an eight-year carryforward rule to ease the transition to the ordinary corporate rules which will apply to all losses from 1986 onward.

This transition rule for thrifts limits relief to the substantial interest rate losses incurred by the industry in the early eighties. The amount of net operating losses expiring before 1990 are estimated by Price Waterhouse to be $13 billion if no change in the law occurs during the 5 year period. The net effect of the proposal to allow thrifts to extend the current law carryforward period for net operating losses incurred between tax years 1981 and 1985 to eight years would decrease tax revenues by $300 million according to Price Waterhouse from 1986 to 1990. This result would appear to be in direct conflict with the estimate of the $13 billion NOL overhang. There are, however, several reasons why the $300 million revenue loss estimate is, if anything, the maximum cost of the transition relief we advocate.

The assumptions used for projecting income are relatively optimistic reflecting what appears to be a return to general profitability within the industry. Nevertheless those institutions which have suffered the greatest NOL losses are also likely to be the slowest to return to profitability. Utilization of expiring NOLs to any great extent is thus a function of an institution's prospects for a quick return to profitability.

Compare, using Table 3, those losses expiring in 1986 and 1987 without the NOL carryforward proposal to those in 1989 and 1990 with the NOL carryforward proposal. It is clear that only a small portion of those losses that would otherwise expire in 1986 and 1987 can be used when the NOL extension is granted. Subtracting the NOL expirations without the extension from those with the extension leaves the result that about $970 million in net operating losses that would otherwise expire can be used to offset taxable income. In the roughest terms, 36 percent of $970 million is equal to $350 million, which is close to the revenue estimate of $300 million. (The difference can be attributed to the graduated rate structure and the thrift method bad debt deduction, which reduces taxable income after NOL's are subtracted.)

TABLE 3

Summary of Net Operating Loss Expirations
Under the Ways and Means Bill
With and Without the 1981-1985 8-Year NOL Carryforward Option
1986 through 1990
($ millions)

Year	Without NOL Carryforward Option	With NOL Carryforward Option
1986	647.3	0.0
1987	3,673.0	0.0
1988	2,622.0	0.0
1989	3,437.6	612.7
1990	2,557.5	2,736.1
Totals	12,937.4	3,348.8

Analysis of proposals conducted by Price Waterhouse and based on a survey of savings and loans conducted by the U.S. League of Savings Institutions.

The overall thrust of tax reform is increased equity and efficiency. This NOL issue is one where the basic question is one of fairness and, therefore, the outcome should not be revenue-driven.

CASH TO ACCRUAL ACCOUNTING

The Administration and House tax proposals would limit the use of the cash accounting method employed by virtually all savings institutions as well as a wide array of other service industries. Under their proposals, the cash accounting method would be limited to firms which have average annual gross receipts (over three years) of $5 million or less and do not use any other accounting method regularly to determine income, profit or loss.

Under the accrual method, generally speaking, income and expenses are recognized and deducted when incurred; the cash method recognizes income and deducts expenses when they are received or paid in cash or its equivalent.

These new cash accounting restrictions would be effective for taxable years beginning January 1, 1986. However, taxpayers would be permitted to spread the income adjustment that results from the switch between the two accounting methods ratably over a six-year period.

The rationale offered for this provision in the Administration package, while plausible, is certainly not convincing. The Supreme Court has recently noted that there is no implicit presumption that financial accounting and tax accounting should be in conformity. In Thor Power Tool Co. v. U.S. 439 U.S. 522 (1979), the Court stated:

> "The primary goal of financial accounting is to provide useful information to the management, shareholders, creditors, and others properly interested:...the primary goal of the income tax system, in contrast, is the collection of revenue...Given this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable."

In addition, it is incorrect to assume that the Administration proposal would necessarily eliminate any discrepancy between the financial statement and the tax return. Even if both were on an accrual basis, significant differences, such as depreciation recognition, would remain. In fact, the above discussion on the proposed elimination of reserve accounting for bad debts represents an inconsistent movement in the Administration package away from accrual methodology.

Cash accounting is somewhat of a misnomer. Tax returns prepared on this basis do not completely follow a receipts and disbursements methodology -- depreciation is a non-cash basis spreading of the cost of acquiring fixed assets used in the business. The major problem that Treasury has with the overall approach followed by cash basis taxpayers is the somewhat greater flexibility afforded.

Cash accounting does indeed provide thrifts with some important tax management alternatives not available under the accrual method. Moreover, an abrupt change from cash to accrual accounting would create an additional burden for thrift institutions at a time when they are struggling to restructure their portfolios and recover from the prolonged earnings squeeze which has weakened them. The flexibility provided by cash accounting is important to the continuation and success of this recovery process.

In addition, thrift institutions would face another adverse financial statement impact from this tax law change if FASB adjusts the way that future tax liabilities should appear on the balance sheet.

Unlike the situation with the thrift bad debt reserves, deferred tax provision has been made for the timing differences produced between book and tax income from cash/accrual discrepancies. However, as Table 1 above shows, the statutory thrift rate has always been less than the 33% or 36% proposed in the Administration or House Tax packages respectively. Under new FASB rules, it would become necessary to increase the financial statement provision for these timing differences to reflect any higher tax rates (33% under the Administration proposal or 36% under H.R. 3838).

The cash to accrual switch could have an immediate financial statement impact of about $400 million. As a side-benefit of the retention of a 5% special thrift bad debt reserve addition, consistent with actual experience, this adverse impact would be moderated.

However, even if the prejudice against the overall cash basis of accounting prevails, the League would suggest that a deeper analysis of the situation would argue for, at most, a limitation in the use of this method by savings institutions. The major reason the Treasury might have for opposing the legitimate use of the cash method is its potential for creating timing differences whereby one taxpayer's expense is not simultaneously picked up as another taxpayer's income. According to the Price Waterhouse study, the change from the cash method of accounting to the accrual method would cause thrifts to have to recognize approximately $650 million of deferred income in each of the next 6 years. This increase in taxable income would result in an additional tax liability of $1.2 billion during the 1986-90 period.

Even though timing differences would be a valid theoretical concern, for savings institutions the problem does not arise on the vast bulk of the transactions on either side of our balance sheet. As financial intermediaries specializing at the retail, individual taxpayer level, our cash basis business accounts interact with cash basis individual taxpayer returns.

On the savings deposit side, the vast bulk of our liability base, the constructive receipt doctrine and the countervailing deductibility of deposit interest expense as credited to accounts essentially produces a near-perfect match. On the asset side, the preponderance of individual mortgage loans owed by cash basis mortgagors gives an equal offset to our cash basis recognition of income thereon.

Any move away from the cash basis on the bulk of our assets and liabilities would, in effect, produce rather than eliminate the type of distortion intended by the switch to the accrual basis. A clear instance of the asymmetries caused by the accrual basis for our institutions is the problem created by applying the original issue discount (OID) rules to individual mortgage transactions by the 1984 tax act.

Under DEFRA, savings institutions would be placed on an accrual basis for certain purposes though borrowers would be limited to cash basis interest deductions. Consequently, lenders would accrue more income than borrowers could deduct as an expense. Instituting asymmetries in favor of the Treasury is no solution to asymmetries against the federal revenues. Analogous problems would arise from the present proposal to mandate accrual accounting generally.

The U.S. League cautions that financial statement damage caused by switching from cash to accrual accounting will be out of all proportion to the revenue raised and recommends that savings institutions be permitted to continue the use of cash accounting for tax purposes. At the very least, this method should be retained for reporting income from currently held long-lived financial assets and the financed interest, origination points and deferred interest thereon. If the change to accrual accounting occurs then an extended 10-year phase-in period should be provided.

DELAY REPEAL OF REORGANIZATION RULES FOR FINANCIALLY TROUBLED THRIFTS

The U.S. League is particularly concerned about the House bill's immediate repeal of a number of favorable tax rules which have assisted resolution of our troubled thrift problems. These rules were enacted in the 1981 Economic Recovery and Tax Act to permit the acquisition of a "financially troubled" thrift to qualify as a tax-free reorganization without regard to the continuity of interest requirement (Section 368(a)(3)(D)). By contrast to the immediate repeal of this sector found in H.R. 3838, the Administration's package would have continued to permit an acquiring corporation to assume the failing thrifts' assets and liabilities in a tax-free reorganization without regard to continuity-of-interest through the year 1991. Similarly, the House-passed bill would terminate on January 1, 1986 section 597 of the current code which provides for tax-free treatment of certain FSLIC payments made to the acquiring corporation in connection with an supervisory acquisition. The President recommended continuation of Section 597 until 1991.

As a further point, we see no rationale for confining these special tax code sections designed to facilitate supervisory resolution of problem cases to the FSLIC alone. Given the strains placed on the Federal Deposit Insurance Corporation over the past few years, we would strongly support extension of these provisions to the FDIC assistance payments already made in the past and to be made in the future. Uniformity in these rules for all thrifts would be one beneficial example of tax code neutrality.

These 1981 tax law changes were intended to assist the FSLIC in attracting merger partners for the growing number of supervisory cases -- thus assuring depositors that their savings were secure and minimizing payouts from the FSLIC insurance fund. Without continuation of these vital thrift supervisory provisions the struggling FSLIC insurance fund will continue its dangerous erosion. Supervisory mergers allow the Board to resolve problem cases at costs significantly less than the cost of liquidation and with minimum disruption to depositors. A drastic increase in liquidations of defaulted institutions would place the insurance fund under more critical stress than it already faces. Despite recent moderation of interest rates, the challenge to the adequacy of the FSLIC fund has never been greater. This is true even without the repeal of the favorable supervisory tax provisions contained in H.R. 3838.

Unfortunately, time has permitted savings institutions to only partially restructure their balance sheets in order to enable them to compete in the uncertainty and volatility of the newly deregulated financial environment.

The U.S. League, therefore, fully agrees with the President that the thrift industry still has not fully recovered from the devastation of the 1981 and 1982 loss years. We, therefore, strongly support the President's recommendation to delay repeal of these important supervisory assistance Sections at least until 1991.

In fact, we would prefer congressional review at that point rather than a definite sunset. Currently, we project rather healthy earnings in the aggregate for the business for 1985 and beyond but should a breakdown in the budget process unsettle financial markets and increase rates sharply, these projections could quickly require a downward adjustment. In addition, even though the business on average may rebound rather strongly, the FSLIC and FDIC caseloads may be slower to shrink and a hard and fast target of 1991 may be impossible to meet.

SECTION 321 OF THE HOUSE BILL, CORPORATE MERGERS AND REORGANIZATIONS

The impact of this section on routine savings institution transactions is both pervasive and serious. The problem is the interaction in the House-passed measure between the changes made in special thrift merger/reorganization rules and separate changes made in merger/reorganization rules for corporations generally.

The initial Treasury reform draft in this area recommended the immediate repeal of the special savings institution merger/reorganization rules enacted as part of the 1981 tax bill.

These special provisions did two things: conferred tax-free status on Federal Savings and Loan Insurance Corporation assistance payments (new code Section 597) and enabled the Bank Board to certify that the continuity of interest tests could be measured by the transfer of deposits from a troubled institution to a healthy acquirer, rather than by the exchange of stock between acquirer and acquired (code Section 368(a)(3)(D)(ii)).

Both the League and the Bank Board protested the removal of these tools available to the FSLIC to resolve problems. These twin tools enable the FSLIC to economize on hard dollar outlays by granting tax free treatment and thus carryover of net operating loss (NOL) tax shelter when an institution is in default or in danger of default. And, if hard dollars outlays are unavoidable, fewer need actually be paid over since they are tax-free.

The President's package released in May 1985 recognized the importance of these special tax provisions in helping to resolve the failing thrift problems and retained them until year end 1990. The House measure, however, returned to the posture of immediately scrapping the special rules. It also added, late in the game after the both House and Senate hearings on the Presidential package, a complete rewrite of the general rules dealing with the carryover of tax attributes when a loss corporation is acquired by a healthier entity.

It is the interaction of these rules -- special and general -- which makes the situation so complex. It is no longer enough to keep the special rules because they would simply qualify troubled thrifts deals for the general rules which have now changed in an adverse way.

The general rules for dealing with tax attribute carryovers by corporations are in disarray.

The 1976 Tax Reform Act made significant technical changes in how NOLs would be treated. But the effective date of these 1976 changes was continually deferred.

Before 1976, the ability to use the loss corporation's NOL carryforwards was limited unless the stockholders of the loss corporation continued to hold at least 20% of the stock of the post-merger entity. For each 1% in ownership short of that 20% value, 5% of the NOL shelter would be lost.

The Bank Board certification authority enables this 20% test to be met by the transfer of deposits rather than stock. Normally in a FSLIC-assisted merger, the stockholders of the hospital case are wiped out so that, absent this special thrift rule, the transfer of NOL shelter to the problem case acquirer would not be possible.

Other technical issues arise such as the Single Return Limitation Year rules for acquisitions by a holding company affiliate and special rules for carryovers of unused tax credits and capital losses but the key item is the 20% threshold value.

The reason is that the long deferred 1976 act changes finally kicked in on January 1, 1986. The threshold value under the 1976 law is 40% which means that it is tougher to get the full benefit from an NOL.

The 98th Congress before adjourning did not agree to continue the process of deferring the 1976 changes.

The House bill has proposed much more sweeping changes in the general rules than were made back in 1976. The basic question now is, which of the three sets of rules should be used to analyze a reorganization: the pre-1976 rules that had an extended life til 1986, the 1976 changes that finally kicked in as of 1986, the House bill provisions which may (or may not) eventually be enacted.

This last alternative is the least attractive from a savings institution perspective. The use of NOL carryforwards will be limited if there is a change in ownership of more than 50% of the value of a loss corporation's stock, however that change is effected.

In addition, the NOLs are disallowed if a 50% (not 20% or 40%) continuity of interest test is not passed by a reorganization attempting to be included in the tax-free reorganization categories. Finally, and perhaps most importantly, the definition of a pre-acquisition NOL will be broadened to include any "built-in" losses. Such built-in losses for a savings institution would include the shortfall in the market value of the loan portfolio from its book or face value. This is a very significant broadening of the NOL concept to include potential but not realized tax losses.

The transfer of ownership rights that triggers the carryover limitation or elimination can occur in one of two apparently mutually exclusive ways. First by an "owner shift" which reshuffles the holdings of stock of a corporation enough so that even though the corporation continues its autonomous existence, its ownership is so radically changed that it is essentially a new entity. (The report language lumps in mutual-to-stock conversions in that category.) The second transfer can occur in a tax-free corporate reorganization. The trigger here is the above-50% continuity of interest test.

Despite the report language accompanying H.R. 3838 which apparently puts conversions of healthy institutions into the owner-shift category, these conversion transactions have hitherto been classified as tax-free reorganizations and may thus escape the de facto elimination of attribute carryover.

Whatever the intended effect on a healthy institution conversion, the impact on a supervisory conversion/merger is horrendous. Here, under present supervisory practice, the FSLIC forces the conversion of an insolvent mutual to stock form and merges the problem case into a healthy stock institution.

Because of the loss of the certification of continuity of interest via deposit transfers, the "stockholders" of the disappearing entity will have zero holdings of the stock of the acquirer. Since no stock is transferred -- the acquiring company will not give value to acquire a problem -- such a transaction can no longer qualify as a tax-free reorganization but is deemed a taxable acquisition of assets and assumption of liabilities. The assets will be valued at market and will therefore implicitly carry market yields. Accordingly, the routine return of principal will be recast as a market discount yield adjustment generating added taxable income. This will immediately turn off potential acquirers threatened by positive taxable but negative economic income.

For transactions which do meet the test as a tax-free reorganization, the general rule for the annual limitation on using up NOLs of the acquired institution is the transferred continuing stock value of the loss corporation times the long-term tax exempt rate.

Furthermore, even apart from absorption rates of traditional NOLs the tax treatment of other post-merger transactions will differ sharply. A subsequent sale of mortgages at a loss from their book value which would generate an immediate tax loss under current law would be subject under the new rules to the above, slower tax shelter NOL absorption rate.

These losses would now be considered as part of the NOL carryover subject to limitation if the sale took place within 10 years of the merger (or conversion). This would sharply reduce the ability of institutions to make a fresh start by selling off a portion of the loan portfolio, servicing retained, to redeploy assets for higher yields or better maturity or duration match.

Whether this concept of defining subsequent events as NOL has merit for regular corporations, it does not help savings institution restructuring efforts. In addition, it appears to have technical flaws as drafted when applied to that segment of a mortgage portfolio on which the total principal balance will definitely be repaid but which simply carries below market coupons.

Overall, these tax changes certainly do not make recapitalizing the business by conversions or managing the caseload of the FSLIC or the FDIC any easier. In general, anything which can be done to facilitate conversions will help out the agencies first by strengthening the capital base of the converting institution and rendering it less likely to be a problem case itself, and second, by placing that converted institution in a capital position more conducive to merger with a failing shop.

The U.S. League feels strongly that existing law as regards troubled thrift resolution should be retained and indeed, in light of the burden facing the FDIC as well as the FSLIC, extended to FDIC-insured thrift institutions. Furthermore, any conversion of a thrift from mutual to stock form under either Bank Board or FDIC rules should continue under the present statutory framework.

INCENTIVES TO ENCOURAGE ADDITIONAL SAVINGS SHOULD BE EXPANDED

The U.S. League applauds the President for his proposal to expand the spousal IRA contribution to the maximum $2000. The American housewife who usually works more than a full day in the home should not be denied the same retirement benefits of a wage earner working outside the home. The IRA account is one of the major inducements for long-term savings and spousal IRA parity will increase this important source of long-term capital.

However, we are extremely disappointed that H.R. 3838 ignores the President's spousal IRA initiative and indeed adopts restrictions on existing IRA accountholders. The provision at issue would offset dollar-for-dollar an IRA contribution by whatever amount is contributed to a 401(k).

The 401(K) contributions by an employee would also be limited by a $7000 ceiling. If an investor had a 401(k) plan he would receive greater tax benefits (larger contribution amount, employer matching contributions, better access to savings) than he would under an IRA. The dollar-for-dollar contribution offset discriminates against the IRA account by requiring the investor individual planning for his or her retirement to make a choice between investments. If the saver chooses the IRA investment he or she is prohibited from investing in the 401(k) beyond the $2000 IRA maximum..

Rather than offsetting one savings investment against the other, the tax reform bill should be encouraging additional investment alternatives. The successful IRA account has attracted stable long-term savings dollars into our institutions and made a better match for our thrift mortgage investments.

The IRA program also represents our government's attempt to craft a private retirement supplement to our strained Social Security system. Encouraging individuals to save for their own retirement is an important social objective and will eventually prove to be a small cost to ease the growing pressure on Social Security. The universal IRA account has been the best designed savings vehicle for developing a private retirement system and substantial progress has been made in educating the public to utilize the IRA account to build for their retirement. To date $190 billion has been attracted by the entire IRA market. Our savings institutions alone hold a substantial share (27.3%) of the growing IRA savings. But more important is the fact that IRA has been popular with the savings customers - attracting this long-term savings dollars as originally intended under ERISA.

Opponents of the IRA have always asserted that IRA savings are shifts from other savings accounts and therefore very expensive without generating any new savings. While this may have been true in the beginning, few shifts actually occur today unless they are from a more liquid account to the longer term IRA where the liquid account is then quickly replenished. This short-shifted savings certainly meets the definition of new savings from our industry's perspective.

The U.S. League strongly objects to the discriminating offset employed by the House in linking the IRA and 401(k) (H.R. 3838). The linkage between the IRA investment and the 401(k) should be removed in order to expand available investment alternatives with the hope of encouraging greater planning by individuals for their retirement years.

SUPPORT FOR LOWER CORPORATE TAX RATE

The U.S. tax code has always been voluntary and, therefore, compliance becomes a critical factor in measuring efficiency and fairness. Without fairness and perceived equity, tax code compliance will be quickly eroded. Examples of tax code non-compliance, however, seem to be on the increase and, therefore, the U.S. League supports effective measures to improve compliance and reduce the growing underground economy.

An important element for improving tax code fairness, simplicity and compliance is the reduction in overall corporate and individual tax rates. Easing the perceived tax burden through lower rates improves voluntary compliance, reduces the attraction of shelter provisions and other tax avoidance schemes, and simplifies the existing code. We applaud the goal of lower corporate tax rates and urge the Senate not to follow the House approach of increasing corporate tax liabilities to pay for last minute amendments, but to retain the corporate tax rate at 33% without delaying the effective date or phasing it in.. Reduced corporate, as well as individual tax liability, will in our view increase taxpayer compliance and stimulate economic growth.

H.R. 3838 EFFECTIVE DATES NEED TO BE DELAYED

The U.S. League of Savings Institutions would like to mention a number of effective dates under H.R. 3838 which impact our institutions and our supervisory agencies and which need to be adjusted to minimize adverse economic effects. In each of these cases, the outcome of significant investment decisions could be radically changed depending on the extent and effective dates of the revisions in the revenue code proposed by the House-passed bill.

The first item where the eventual selection of an effective date could have a major impact is the downward adjustment in the special thrift bad debt reserve provisions from the 40% level of Section 593 of the current code to 5% as proposed in Sec. 801(b)of H.R. 3838. As noted previously, the reduction in the allowable bad debt allocation is scheduled for January 1, 1986 though the reduction in the general corporate rate is a mid-year adjustment. The net result of this timing discrepancy is to produce an applicable thrift tax rate of 31.3% in 1985 (under current law), 39.0% in 1986, and 34.2% in 1987 and thereafter. This potential spike in tax rates would substantially affect operating strategies for qualifying thrift institutions for the next two years and would inevitably introduce a completely artificial distortion into investment decisions and other transactions in that time period.

The impact of this uncertainty is magnified by the mandated switch from cash to accrual accounting for institutions with more than $5 million in annual gross receipts (Sec. 902 of H.R. 3838). Many of our institutions presently use the cash method but essentially all would be switched to the accrual basis. Adjusting the effective dates to forestall these distortions would be a helpful technical correction to the reform package.

Concerns over the above provisions are unique to thrift institutions. Our institutions also share some concerns with the general corporate sector over the proposed revisions to the carryover of net operating losses (NOL) by corporations undergoing a change of ownership (Sec. 321 of H.R. 3838). Here again, however, the particular nature of a savings institution structure and its operations has added further complexity to an already intricate section of the revenue code.

The NOL carryover rules in corporate mergers are governed by Section 382 of the present code. That code section was amended by the 1976 tax act but, as explained elsewhere in this statement, the effective date of these changes has been continually deferred and the present tax reform package takes yet another approach to this topic. In the meantime, pending the outcome of that overall reform effort, a further postponement of the 1976 changes has been advocated in the Senate as a stop gap measure. As a result, parties to a prospective merger must analyze the transaction from three quite different perspectives.

The unique element in the depository institution sector is the role of the Federal Savings and Loan Insurance Corporation and the Federal Deposit Insurance Corporation in arranging mergers as solutions to problem cases. In these transactions, the acquiring institution is compensated for undertaking the merger transaction by the federal insurance-of-accounts funds rather than buying out the owners of the acquired institution.

The uncertainty as regards the treatment of NOLs and carryover basis could have a chilling effect on any insurance-fund rescue operations. In addition, in some cases, the proposed rules would also inhibit the ability of capital-deficient institutions to increase their reserves to acceptable regulated levels by conversion from the mutual to the stock form of ownership.

Whatever the merits of the three variants of tax law in this area -- current law, the 1976 amendments, and the new approach of the House-passed package -- there is no possible benefit from permitting the current level of confusion to put beneficial mergers and conversions "on hold." If the proposed changes in the tax reform package are to be adopted -- and we are by no means convinced that they fit the structure of depository institution mergers -- it would be needlessly complicated to trigger the 1976 changes for an interim period pending enactment of those final rules. The U.S. League strongly urges the Congress to continue the existing tax rules governing mergers of depository institutions, including the special FSLIC reorganization rules, or, at a minimum, stipulate January 1, 1987 as the earliest effective date for Code revisions.

FEDERAL DEDUCTIBILITY OF STATE AND LOCAL TAXATION

Finally, we come to the interaction of the proposed changes in individual tax laws with the position of savings institutions as financial intermediaries. The key issues here involve the federal deductibility of taxation imposed by lower levels of government.

A great deal of discussion has involved the impact on real estate values of the denial henceforth of the deductibility of local property taxes. The U.S. League shares these concerns as will be outlined in a moment but first it may be helpful to analyze another, little-appreciated implication of the non-deductibility of state income taxes.

Non-deductibility of these taxes will inevitably disadvantage all forms of taxable debt instruments vis-a-vis U.S. Treasury and agency obligations. Presently, wherever state or local income tax is levied, interest on federal obligations is exempt, just as municipal bond interest is, in turn, exempt from federal taxation. Savings accounts, though of virtually equivalent safety in view of the federal guarantee, must pay a somewhat higher rate, other things being equal, to cover the double bite of taxation imposed at both the state and federal levels.

That savings account rate spread to the equivalent maturity along the Treasury yield curve is narrowed by the federal deductibility of the state tax liability on the saving account interest. In effect, the federal tax bite is reduced in proportion to the marginal tax rate of the investor. If, however, the rules are changed so that no offset to federal tax liability is allowed for the state income tax bite, the yield spreads from doubly-taxed savings accounts to single-taxed U.S. obligations must widen. In effect this provision will enhance the marketability of Treasury obligations at the expense of every other debt instrument. There is no guarantee that the general level of interest rates will fall enough to overcome this adverse impact on housing affordability.

Of course, the loss of the deductibility of property taxes would also adversely affect the after-tax cost of homeownership. Again, there is no guarantee that the presumed decline in mortgage interest rates from increased savings at lower tax rates will more than compensate for the loss of the property tax deduction. Even if interest rates do decline following tax reform, that would provide little consolation to current owners facing higher home occupancy expense unless that homeowner has an adjustable rather than a fixed rate loan. A contention that the lower income tax rates would always offset the loss of the property tax deduction is demonstrably untrue. At the very least, in a relative sense, housing would be a less attractive investment.

Certainly it has to be admitted that the exorbitant rates of return on highly-leveraged, fixed-rate financed real estate investment achieved in the inflationary era of the late 1970s could not and should not be sustained. In addition, some of the alarmist analyses of the impact of the loss of the property tax deduction may have gone overboard in predicting massive declines in real estate values. Nonetheless, given the fragile nature of both the housing recovery and the rather high delinquency rate already produced by the slowdown of inflation and the uneven geographic distribution of the recovery from the recession, even a 2-5% decline in relative real estate values could produce additional, unnecessary problems for both borrowers and lenders.

The U.S. League supports the House action to retain the deductibility of state and local taxes and asks the Senate in light of the foregoing reasons to proceed with caution in this area.

In conclusion, I wish to thank you, Mr. Chairman, and this distinguished Committee for providing an opportunity to review the provisions of the House-passed H.R. 3838 and their impact on thrift and other financial institutions. By retaining a reduced thrift bad debt reserve opportunity, an avoiding recapture of past bad debt reserve allocations (with immediate and severe financial statement consequences), the House bill, did, in one respect, improve upon the package forwarded to the Hill by the Administration. However, many problems remain in this comprehensive legislative effort: the absence of a transition rule for the carryforward of net operating losses incurred during the thrift crisis years of this decade; the immediate elimination of special code sections essential to the FSLIC and the FDIC as they try to cope with problem cases, the arbitrary and mandated use of accrual rather than cash-basis tax accounting by financial intermediaries; the barriers to mutual to stock conversion inherent in general corporate revisions of the treatment of loss carryover in mergers and acquisitions; the unfair linkage of IRA and 401(k) retirement savings limits and the disincentives that linkage creates to planning by individuals for their retirement years; the staggered timing problems of repeal of existing provisions and the reductions in corporate rate; and the special problems for financial institutions of proposals to eliminate the deduction for state and local income and property taxes. Though beyond the scope of this testimony, our League also shares with other housing-sector groups the concern about such proposed changes as the stretch out in depreciation schedules on real property.

In short, much remains to be done if the Congress is to provide a "fair" and "simple" tax reform package. We are confident that the Members of this distinguished Committee will assist in that effort.

I appreciate this opportunity to present the views of the U.S. League and its 3,400 member savings institutions on H.R. 3838 and look forward to your questions.

The CHAIRMAN. Thank you, Mr. Morris.
Mr. Albers.

STATEMENT OF KENNETH F.X. ALBERS, CHAIRMAN, PROVIDENT SAVINGS BANK, JERSEY CITY, NJ; CHAIRMAN, NATIONAL COUNCIL OF SAVINGS INSTITUTIONS

Mr. Chairman and distinguished members of the Committee, I am Kenneth F.X. Albers, Chairman of Provident Savings Bank, Jersey City, New Jersey. I am appearing today in my capacity as Chairman of the National Council of Savings Institutions, a trade association consisting of approximately 600 savings banks and savings and loan associations with total assets in excess of $430 billion.

We are very pleased to have the opportunity to testify on the implications of tax reform for the thrift industry. We commend you for scheduling these hearings because the impact of proposed tax changes on thrift institutions is extensive and in some cases severe. We hope you will share our concern and let your colleagues know of needed changes if thrifts are to have the opportunity to restructure and to operate profitably, in today's economic and competititve environment.

GENERAL COMMENTS ON H.R. 3838

While the Council has a number of specific concerns in relation to H.R. 3838, I would like to begin with some general comments about the bill. First, H.R. 3838 means a substantial tax increase for the thrift industry. Currently thrifts pay an effective tax rate of approximately 32 percent. Estimates show that, under the bill passed by the House, the thrift rate would increase substantially--perhaps by as much as 16 percent in some cases. This is in contrast to a number of industries who will see substantial tax decreases under H.R. 3838.

The impact on thrifts is severe because of the sharp cutback in the bad debt reserve allowance contemplated by H.R. 3838. The bad debt reserve allowance is the major tax preference granted the thrifts under the tax code. This cutback combined with other provisions of the bill, such as requiring a switch from cash to accrual accounting, creates a substantial tax increase for thrift institutions Corporate rates would have to be substantially lowered to compensate for the proposed changes in other provisions.

Secondly, there is a need to make clear that effective dates of provisions in the bill in general will be in future years. The fact that most effective dates are set at January 1, 1986 makes it difficult to effectively plan for 1986 or, in fact, future years. In some cases, such as the treatment of FSLIC assistance, the effective dates are even earlier in 1985. Retroactive tax changes unfairly penalize institutions who relied on the then existing law to plan and execute business activities. We ask you in the Congress to take steps to assure the public that effective dates will be in future years except for needed transition rules.

The impact of the effective dates is exacerbated by the fact that "preference" provisions are repealed as of January 1, 1986 while rate decreases do not take place until July 1, 1986. This has a substantial impact on thrift institutions.

NET OPERATING LOSS (NOL) CARRYOVER

One of the major areas of impact of the House Bill is in Section 803 which affects the treatment of net operating losses of thrift institutions. This section has substantial impact because certain transitional rules were not included in the House bill.

Before explaining the House Bill provisions, let me put the net operating loss provisions in historical perspective. Congress granted a net operating loss carryback/carryforward to smooth out taxable business income for those companies whose income widely fluctuates from year to year. The NOL deduction provides additional operating income and cash flow in severe loss years through NOL carryback refund claims. It also provides a cushion through NOL carryforwards in subsequent years while the loss company regains viability.

Most companies have an NOL carryback of 3 years and an NOL carryforward of 15 years. (The carryover was increased from 7 to 15 years in the Economic Recovery Tax Act of 1981). Thrift institutions have a 10-year carryback and a 5-year carryforward.

Traditionally, due to the nature of their business and because of reductions in allowances for bad debt reserves, financial institutions have operated under a longer total carryover period and with a longer carryback period than other businesses. The NOL carryback has provided thrift institutions with a needed cash flow and income cushion against the high level of losses during the past several years. In fact, it may have helped a number to remain viable.

The House Tax Bill would move financial institutions to the same carryover basis as other taxpayers - 3 years back and 15 years forward. The carryforward period granted under this proposal could be quite beneficial to savings institutions if provision can be made to cover some part of existing losses in the carryforward provision. The losses experienced by thrift institutions from 1979-1982 have caused many institutions to use the entire 10-year carryback and move into the 5-year loss carryforward. During the period since 1979, the thrift industry has experienced substantial deregulation, which took the form of elimination of controls over deposit rates and limited increases in investment authority. Unfortunately, large fluctuations in the general level of interest rates resulted in violent swings in the industry's cost of funds, while contractual long-term asset rates remained relatively unchanged. This created substantial losses to thrifts. Even if profits continue to grow at the rate that is now evident, many of these institutions will have NOLs that will expire unused during the next 2-5 year period. This is particularly true for those institutions which, in cooperation with FSLIC or FDIC, acquired failing institutions with substantial losses through mergers.

In the uncertain interest environment facing thrift institutions and because of the need for these institutions to have every opportunity to restructure, it is essential that there be an extension in the carryforward provisions of the Code for existing net operating losses of thrift institutions.

We are asking that transition rules allowing a 3 year extension of the 5 year carryforward be granted for net operating losses incurred by thrifts in the period 1981 through 1985. This would bring the carryforward to a total of 8 years for this period. Losses incurred beginning in 1986 would then be subject to the new rules proposed by H.R. 3838. This transition period is extremely important if thrift institutions are to complete the recovery and the restructuring now taking place.

BAD DEBT RESERVE DEDUCTION

The primary tax code provision benefiting thrifts relates to a section of the law that allow deductibility of reserves for bad debts. Under current Internal Revenue Code (IRC) Section 593, savings institutions are granted a special bad debt deduction known as the percentage of taxable income method. Under this method savings institutions are allowed a deduction for addition to loan loss reserves for qualifying real property loans equal to 40 percent of taxable income. There are several limitations on this deduction, the foremost of which is a requirement that 82% (72% for a mutual savings bank) of an institution's assets be in narrowly defined housing related assets. The level of the bad debt deduction allowed drops below 40% as the percentage of assets invested in these areas is reduced. The special bad debt deduction is not allowed to be taken if investment in specified target assets drops below 60% of assets. This special bad debt deduction is subject to corporate preference cutbacks which drop the value by 20%. In addition, savings institutions can use the percentage of loans reserve method available to commercial banks and the modified experience method.

H.R. 3838 reduces the allowable bad debt reserve deduction from 40 percent to 5 percent for savings and loan associations and savings banks. The provision also allows the continued use of the experience reserve method. In order to receive the 5 percent deduction, thrift institutions are required to keep 60 percent of assets in housing related investments defined in IRC 7701 (a)(19)(C). This language, known as the Anthony Amendment, was adopted during Ways and Means consideration of the bill to avoid the President's Proposal for total repeal of section 593 with consequent recapture of existing bad debt reserves. Recapture with its consequent accounting requirements, would have been devastating to thrifts.

There are, however, a number of concerns with the provision as it stands in H.R. 3838. The first relates to an apparent error in the drafting of the language which extends the Anthony Amendment beyond its intent by placing an asset test requirement on the use of the experience method of reserves. The explanation of the Anthony Amendment states that experience reserves would continue as under current law. Under current law there are no explicit asset test requirements for use of the experience method contained in section 593. Unfortunately, Section 801 of H.R. 3838 requires a 60 percent asset test for use for any of the reserve methods allowed in the entire section. The language has a particular effect on savings banks who have historically never had to meet an asset test to use the experience method of reserves under section 593. This error needs to be corrected.

Our second concern is more substantive and philosophical. We believe that a 60 percent asset test requirement is a rather high price to pay for a 5 percent bad debt reserve deduction. As this Committee well knows, the Council believes that thrift asset tests in banking law are counterproductive and unnecessary. We also have reservations about thrift asset tests in the tax code unless one receives substantial benefits in return. While the provision is preferable to a total repeal of the bad debt deduction and a recapture with the devastating financial statement impact, it is certainly not ideal. At a minimum, the qualifying assets described in section 7701 (a)(19)(C) should be broadened to reflect additional powers granted by the Garn-St Germain Act, secondary market activities and other facets of modern thrift operations. The preferable approach would be to recognize that the regulatory requirements imposed on financial institutions alone justify a tax recognition of bad debt reserves without the added necessity of a housing asset test. Historically the substantial bad debt deduction was granted to encourage investment in housing. The House bill imposes severe constraints by limiting business options through a substantial, narrowly focused asset test but does not provide any real incentive or reward, if you will, for meeting the social needs mandated by law. Needless to say, this rationale leaves us at a disadvantage to competitors who have no such requirement.

REPEAL OF REORGANIZATION RULES FOR FINANCIALLY TROUBLED THRIFTS

Special rules enacted in 1981 permit the acquisition of a financially troubled thrift institution to qualify as a tax-free reorganization under current law. In addition, present law allows payments by the FSLIC to a thrift institution under these circumstances to be excluded from taxable income. The House Tax Reform Bill would repeal these statutes.

The present law was enacted in 1981 at the request of the FSLIC to provide the optimum circumstances to deal with the need to assist a number of surviving institutions which agreed to merge or acquire weak or failing institutions. Given the current concern over the long term viability of the FSLIC and the need to provide solutions for other thrifts weakened by the economic circumstances of the early 1980's, we question the ~~need for of~~ wisdom of immediate repeal of this law, let alone retroactive repeal. Given the continuing number of problem institutions, it would be wiser to continue this provision and provide a sunset date in the future. Furthermore, it should be made clear by the federal government that funds under federal assistance programs should also not be subject to state or local taxation either.

Additionally, it would appear to us that, as a matter of necessity and equality, that identical treatment should be extended to thrift institutions insured by FDIC. There appears to be no reason to treat the two deposit insuring agencies and assistance given by them to thrifts differently. We would urge this Committee to work with the Finance Committee to assure that these provisions are extended to some future date and that FDIC assistance for thrifts under its jurisdiction be incorporated into Section 597. This is especially important given the language contained in Section 321 which limits the use of net operating loss carryovers in mergers and acquisitions and the failure of Section 803 to include an extended carryforward period for the losses of the early 1980's. These sections together severely limit the options of the industry and the deposit insurance agencies for solving current problem cases in the thrift industry. If these sections are enacted as written, the burden placed on FSLIC and FDIC will be substantially greater even than today.

NET OPERATING LOSSES IN ACQUISITIONS AND MERGERS

The Tax Reform Act of 1985 also contains provisions which restrict the use of net operating losses in an acquisition or merger. Basically, the bill alters the current law limitations pertaining to use of net operating loss carryforwards to set a prescribed rate at which the NOLs can be used in acquisitions. The limitations in the House Bill would apply for taxable and tax-free reorganizations after a change of ownership of 50 percent or more of the loss corporation's equity. Under the formula, earnings available for offsetting losses acquired could be based on the long term bond rate times the loss corporations' equity. In addition, the loss corporation would have to satisfy the continuity of interest doctrine for two years. The provisions substantially tighten current (pre-1986) standards for use of NOLs which allow transfer and use of the net operating losses without limitation if certain conditions such as continuation of the historic business are met.

The net operating loss carryforward restrictions described in Section 321 of H.R. 3838 apply to all corporate taxpayers and not just thrift institutions so we will not dwell extensively on the specific provisions of this section. Also we understand the desire to deter uneconomic and undesirable trafficking in net operating loss carryforwards. We do, however, want to take this opportunity to point out that the burdens of this provision fall more heavily on the thrift industry, which is undergoing a major consolidation, than other industries. We would also point out that reasons for thrift mergers and acquisitions is not simply the use of the NOLs, but the necessity to solve the problem of weak or failing institutions through merger. Restricting use of NOLs will undoubtedly make the cost of supervisory mergers more expensive for the deposit insurance agencies. This action combined with the repeal of "G" reorganiztions for supervisory mergers and taxation of FSLIC assistance could bring both supervisory and voluntary mergers and acquisitions to a halt.

CASH METHOD OF ACCOUNTING FOR TAX PURPOSES

The House Bill proposes to limit the use of the cash method of accounting for tax purposes. Taxpayers would be required to switch to an accural basis for tax purposes unless the business has average gross receipts of $5 million or less. Only certain businesses such as farming, and certain partnerships (law firms and accounting firms) would be allowed to continue to use cash accounting.

This proposal would have a substantial effect on financial institutions which are by a large majority cash basis taxpayers. Even though the proposal includes a transition rule to allow adjustments to be spread over a period of five yars, its impact is substantial. It adds to the complexity of the tax code by removing a simple, straightforward method of tax accounting. It creates uncertainty at a time when stability in the rules is needed. It would accelerate the payment of income tax on income whose funds are not yet actually received. It is an especially onerous step to take at the same time as elimination of favorable tax treatment of bad debt reserves.

Cash accounting accurately reflects income for tax purposes and reflects a method of taxation based on the ability to pay. Therefore, we find little reason to add to the complexity of the Code by abolishing this method of accounting, especially in conjunction with the repeal of the bad debt deduction for thrifts.

RETIREMENT ACCOUNTS (IRAs AND 401(k)s)

The Tax Reform Act of 1985 makes substantial changes in the tax provisions relating to individual retirement accounts and 401(k) plans. The legislation imposes substantial restrictions on 401(k) plans by limiting elective deferrals by employees to $7,000 (as opposed to $30,000 or 25 percent of income). Even more serious, the bill links an individual's IRA contributions and 401(k) contributions. Deduction limits on IRAs would be reduced dollar for dollar by amounts contributed to 401(k) plans. This would be a first dollar offset which would mean that anyone contributing $2,000 to a 401(k) plan would not be eligible to contribute to an IRA.

These changes would have a devastating effect on the IRA and therefore, on thrift institutions' ability to attract long-term savings through the vehicle of the IRA. IRAs are savings accounts which are marketed extensively by thrifts. Thrifts hold approximately 28-29 percent of the IRA market, amounting to some $58 billion. The linkage between 401(k) plans and IRAs puts thrifts at a disadvantage in attracting these savings dollars. In addition, the link would have an adverse effect on the savings rate in this Country which is already at low levels.

The Council urges the members of this Committee to examine the effect of the proposed linkage between IRAs and 401(k)s on IRAs and on capital formation and savings. In addition, we hope you will share our concerns over the effect of this action on competition between financial intermediaries. It is our hope that the Senate will modify the provisions to dissolve the suggested linkage between these two savings vehicles. We also want to take this opportunity to point out that these tax deferred retirement accounts are the only savings incentives still contained in the tax code.

CONCLUSION

In summary, there are a number of provisions contained in H.R. 3838 which need to be examined and modified because they affect the fundamental operation of thrifts as well as the economic environment in which thrifts operate. We at the Council hope that you will closely examine these provisions and will lend your support for modifications in the Senate bill which is currently being drafted.

Of critical importance are the extension for net operating loss carryforwards, the clarification in the bad debt reserve language and the continuance of tax-free reorganization for thrifts. We urge you to lend your support to needed changes that we have outlined.

I appreciate the opportunity to share the Council's major concerns with you today. I will be pleased to answer any questions.

The CHAIRMAN. Thank you, Mr. Albers.

Just this morning while the hearing has been going on I received a letter from Mr. Seidman, the chairman of the FDIC, and I won't take time to read the whole thing. I will include it in the record, but he makes the comment:

> The FDIC's first concern is the termination of the bad debt reserve deduction for banks with assets of more than $500 million. H.R. 3838 retains present law regarding use of bad debt reserves for small banks. Based on the FDIC's experience in examining both large and small banks, we have concluded that discouraging the use of bad debt reserves is not consistent with the economic results of the banks current operations.

So we'll include that in the record. He goes into much more detail, but as has been said many times here today, it doesn't make a great deal of sense to worry about the safety and soundness of the financial institutions of this country and then change some of the tax rules that would add to their problems.

[Copy of Mr. Seidman's letter follows:]

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

OFFICE OF THE CHAIRMAN

February 5, 1986

Honorable Jake Garn
Chairman, Committee on Banking,
Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

The FDIC would like to comment on two tax-related provisions that are of particular importance to the safety and soundness of the banking system and to the security of our deposit insurance fund. We would appreciate it if the following comments could be made a part of the record of your hearings presently being held on the effect of tax reform on the banking industry.

The FDIC's first concern is the termination of the bad debt reserve deduction for large banks, i.e., banks with assets of more than $500 million. H.R. 3838 retains present law regarding the use of bad debt reserves by small banks.

Based on the FDIC's experience with examining both large and small banks, we have concluded that discouraging use of bad debt reserves is not consistent with the economic results of a bank's current operations.

The size of a bank's loan loss allowance figure has real significance. The need to add comparatively large amounts can have undesirable consequences because increases reduce reported earnings and net worth. A publicly owned bank or bank holding company that has to make material increases to its allowance could see the market price of its outstanding securities fall and the cost of its purchased money rise. A publicly or closely held bank could be required by its Federal bank supervisor to raise additional capital and adopt appropriate plans to improve the loan portfolio, which may result in the bank's board of directors dismissing the senior loan officials.

Taking the reserve method away from large banks does not eliminate a preference. Rather it denies deductions for one of the most significant expenses that banks are presently incurring and weakens the safety and soundness of many institutions in an industry that already has more than its share of troubles. Because of the FDIC's concern for the safety and soundness of individual banks and the continued viability of the industry, I, therefore, strongly recommend that you do not discontinue the reserve method for banks.

The FDIC's other concern relates to the current disparity in federal tax treatment of financial assistance given by the FDIC as compared with that provided by the Federal Savings and Loan Insurance Corporation (FSLIC).

Currently, under Section 597 of the Tax Code, assistance given in reorganizations of financially troubled thrift institutions by the FSLIC is tax free. This status for FSLIC assistance was enacted as part of the Economic Recovery Tax Act (ERTA) of 1981. Unfortunately, FDIC assistance to financial institutions it insures was not specifically included at that time. The FDIC believes that this oversight should be corrected since assistance payments to and reorganizations of troubled financial institutions by the FSLIC and the FDIC are basically identical.

Although H.R. 3838, as passed by the House, would delete this assistance, effective January 1, 1986, the President's Tax Reform Proposal (Chapter 10.04) recommends that the special tax treatment of FSLIC assistance and reorganizations be continued through 1991. We support this extension, and suggest that, in the interim, the Code should be modified to make clear that FDIC payments to financial institutions are likewise not subject to tax.

Your support for bringing about an equalization in the treatment of FSLIC and FDIC assistance, as tax reform legislation works its way through Congress, would be greatly appreciated. Such a result would be of substantial benefit to the FDIC as it seeks to resolve problem cases in the most cost-effective manner possible. Draft language accomplishing this result is attached.

Thank you for your consideration of these comments.

Sincerely,

L. Wm Seidman

L. William Seidman
Chairman

Enclosure

Section 597. FINANCIAL ASSISTANCE

(a) EXCLUSION FROM GROSS INCOME -- Gross income of a bank as defined in Section 581, a mutual savings bank including a bank with capital stock as defined in Section 591(b), a cooperative bank, and a domestic building and loan association, does not include any amount of money or property received from the Federal Savings and Loan Insurance Corporation pursuant to Section 406(f) of the National Housing Act (12 U.S.C. § 1729(f)), or from the Federal Deposit Insurance Corporation pursuant to Sec. 13 of the Federal Deposit Insurance Act (12 U.S.C. § 1823), regardless of whether any note or instrument is exchanged therefor.

(b) NO REDUCTION IN BASIS OF ASSETS -- No reduction in basis of assets of a bank, mutual savings bank, cooperative bank or domestic building and loan shall be made on account of money or other property received under the circumstances referred to in subsection (a).

New language underscored

The CHAIRMAN. Mr. Morris, in your opinion, how would FSLIC be affected if the special tax rules for troubled thrifts were repealed?

H.R. 3838 WOULD INHIBIT CONVERSIONS

Mr. MORRIS. I think if H.R. 3838 provisions go in, it will be devastating. It will strongly inhibit the FSLIC's ability to use the conversion, to approve conversions. It will strongly inhibit the ability to orchestrate mergers and acquisitions. The ability to approve those type of combinations in a tax-free status as a tax-free organization is extremely important to the FSLIC in order to entice the healthier institutions to take on the problem.

The CHAIRMAN. Does just the fact that the provisions on troubled thrifts have an effect, as all of H.R. 3838 does, back to January 1, 1986, has that already had an effect on mergers of troubled institutions?

Mr. MORRIS. I can only speculate. I don't know. We're only 1 month into the year. But my guess is at the moment it has probably stopped any steps forward in that area. Right now the attorneys would have to look at three different laws and try to determine what the tax effects are under those laws and also the other legal implications, but in 1976, the pre-1976 law there were changes in the pre-1976 law that were deferred each year until January 1 of this year, and then H.R. 3838 provisions go into effect supposedly January 1, so do you look at pre-1976 law, do you look at the 1976 law that was deferred until January 1 of this year or do you look at H.R. 3838 in trying to evaluate whether you should acquire or merge both as an acquirer or from the FSLIC standpoint. Yes, I think it's very detrimental.

The CHAIRMAN. With all the things I had to say about H.R. 3838 in previous panels, I believe the worst part of it is the effective date because it isn't just causing uncertainty and problems in the area we're talking about; it is causing uncertainty throughout the entire business community of this country. The worst tax bill we could pass, in my opinion, would not be as bad as trying to guess what we are going to do this year. Some of us are hopeful in the Senate that we can come up with some kind of a mechanism that says whatever we do is not effective until January 1, 1987, because the current retroactive date is having a chilling, disruptive effect in many areas of business. The retroactive effective date of January 1, 1986, doesn't make any sense at all. So I'm hopeful that there will be some common sense at least in the area of effective date, so that people can operate in 1986 and know what kind of business decisions to make, and individual decisions as well. It isn't just the corporate world. I'm sure everybody would agree that we should make a commitment to what that effective date would be to remove the uncertainty from the economy.

I think it's serious enough that it could impact all the numbers that we worry so much about—gross national product, quarterly growth, and all of that. I think it's a big enough issue that it could dampen the entire economy this year, just because of that uncertainty.

Mr. Albers, in your testimony you recommend that the special tax rules for troubled thrifts be continued for now and that a sunset date could be provided to terminate the rules in the future.

In your opinion, what would be a good sunset date?

Mr. **Albers**. I would say some years out, Senator, when the basic problems in the thrift industry appear to be resolved. There are heavy fundamental problems right now as you're aware.

The **Chairman**. Well, 5 years, 7 years?

Mr. **Morris**. Well, the President's proposal provided a sunset in 1991. We think it might be more appropriate to establish that 1991 would be a review date to take a look at the situation at that time and then establish a sunset later on. Rather than establish the sunset now, it might be more appropriate to establish a date at which Congress would review the situation and then establish the sunset.

The **Chairman**. Mr. Morris, do you agree with Mr. Albers' statement that proposed tax changes would mean a substantial tax increase on the thrift industry?

Mr. **Morris**. The definition of substantial is—in the eyes of the beholder, probably any tax increase could be considered substantial. But, yes, I think H.R. 3838 would impose a substantial increase on this industry.

LACK OF TRANSITIONAL RULES IN HOUSE BILL

The **Chairman**. Mr. Albers, you have expressed concern over the lack of transitional rules in the House bill for net operating loss carryovers. What transitional rules would you suggest?

Mr. **Albers**. Extend it another 3 years to a total of 8 years that the thrifts would be able to pick up the net operating losses that occurred particularly in 1981–85. Then on the effective date of the tax bill, any losses incurred in future years, go under the new rule.

The **Chairman**. From your testimony, it sounds like you may not be that unhappy with the bad debt reserve deduction going from 40 to 5 percent if the asset test were changed. Is that correct or did I not hear you?

Mr. **Albers**. We fundamentally don't think there should be an asset test in the tax bill and the National Council doesn't think there should be an asset test, period, in any of the legislation. So we would certainly be concerned with the asset test here because it doesn't mirror what is happening in our industry.

Legislation passed by this committee—recommended by this committee—Garn-St Germain—gave thrifts enormous numbers of new powers. Thrifts are starting to use those powers. You would be very gratified to see some of the figures.

If we are then to be put in a straitjacket, be it a tax bill or something else, we lose the viability that you were trying to create when the other bill was passed a couple years back.

The **Chairman**. But you need to understand that with all the players in Garn-St Germain you would not have gotten those new powers without an asset test to go with it. So it's one of the political facts of life. I'm certain you would like to do away with the asset test.

Mr. **Albers**. But Senator, savings banks have never had an asset test in order to use the experience method of reserving for bad debts under the Tax Code.

The **Chairman**. I understand.

Mr. **Morris**. I would like to comment on the drop from 40 to 5 percent. Actually, it's from 32 percent because of the preference tax. But we support the 5 percent as long as the President's proposal for a 33-percent corporate rate could be reinstated in the law. We feel then, if we increase from 33, 34, 36 percent, whatever it is, then there should be some sort of ratcheting or some sort of adjustment in that 5-percent figure.

The **Chairman**. Gentlemen, thank you very much. We appreciate your being here today.

The committee is adjourned.

[Whereupon, at 11:55 a.m., the hearing was adjourned.]

[Response to written questions of Senators Heinz, D'Amato, and Sasser follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM

DONALD T. SENTERFITT

QUESTIONS FOR BANK/TAX HEARING February 5, 1986

1) Could each of you list, from most onerous to least onerous, which provisions of H.R. 3838 would be most detrimental to you and which you would least like the Senate to adopt?

The American Bankers Association has identified three issues included in H.R. 3838 which are most important to the banking industry. All of these issues have equal importance. They include: the repeal of the existing loan loss reserve deduction for banks and bank holding companies with assets in excess of $500 million, the disallowance of the deduction for 100 percent of the interest expense incurred to purchase or carry tax-exempt obligations, and the change to the current rules on the treatment of foreign tax credits.

Other issues affecting the banking industry include the repeal of the net operating loss rules for banks, the required use of the cash method of accounting, the changes in the income taxation of trusts and estates and the linkage of IRAs and Cash and Deferred Arrangements (401(k) plans).

2) Which provisions could you live with?

We believe the three issues outlined above represent a serious threat to the safety, soundness and competitiveness of U.S. banks. While sufficient safeguards are built into our systems so that a wholesale failure of banks is extremely unlikely, the enactment of H.R. 3838 would, at the very least, significantly slow bank growth and could result in a contraction of bank lending.

3) It has been alleged that the largest banks in our country pay little or no taxes. That is very hard to explain to other taxpayers. Could you explain to me why your rates are so low? Also, could you provide me with estimated costs -- both in dollar figures and in

percentage of income -- to you and the banking industry as a whole of these "other costs" that make your tax rates look so low?

We believe there are three important elements to the way banks are currently taxed. First, banks are generally subject to tax under the same rules as other taxable corporations. Second, the tax benefit a bank receives from purchasing a tax-exempt bond or doing a finance lease, for the most part, is passed directly through to the city or state selling the bond or to the corporate lessee. In general, a bank's bottom-line profit on such transactions varies little from its profit on a straight taxable loan. Third, banks pay over $2 billion annually into the Treasury as a result of the reserves they are required to maintain with the Federal Reserve System. This quasi-tax is in addition to paying all of the costs of regulating banking incurred by the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Federal Reserve System. It is the combined effect of these three elements that determines a bank's true effective tax rate. A survey conducted on 1983 income by the Bank Administration Institute asked banks to recalculate their taxes to reflect the earnings of Treasury on the reserves provided to the Federal Reserve System and a tax equivalent analysis of municipal bond income. The result was an effective tax rate of 43 percent.

4) It is unlikely that your industry will go untouched. We have heard how you will be hurt by the House-adopted tax reform provisions, but what can you offer in their places? Do you have any alternatives?

Even if the provisions we are concerned about are dropped from the bill or are modified, the taxes that banks pay will increase. Repeal of the investment tax credit and changes to depreciation will increase significantly the taxes paid by institutions in leasing. The disallowance of 100 percent of the carrying costs of tax-exempt obligations, even with a transition rule to assure liquidity, would also significantly increase the taxes banks pay.

5) You have provided us with speculation and anecdotes about the possible effects of the banking provisions of the House tax bill. Do you have any facts and figures to back up your assertions that our foreign trade, towns and cities and consumer-borrowers will be hurt by the provisions of the House bill?

We can document the impact on a bank and the cost of each of the provisions that we are concerned about. The repeal of the loan loss reserve will decrease cash flow and in many cases will also result in a reduction of a bank's capital. The combined effect will be a reduction in lending capacity. The imposition of double taxation on foreign source income will cause rates to rise. The inability to deduct carrying costs related to tax-exempt investments also will require banks to raise rates or cease making such loans.

Unfortunately, we cannot document with certainty how this will affect our customers. If H. R. 3838 results in a general decline in GNP it will exacerbate the problems created by the repeal of the loan loss reserve. If H.R. 3838 produced an increase in GNP, then the problems will not be as visible. The effects will still be present but they will not be clearly visible. The impact of the other provisions also depend on too many other factors to make accurate projections.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM

DONALD T. SENTERFITT

FEBRUARY 5, 1986

1) I am concerned with the provision of H.R. 3838 that totally eliminates deductions of the interest to carry tax-exempt securities, mainly bonds. If Congress adopts the elimination of the interest expense deduction, what will be the effect on the bank's ability to purchase or trade in tax-exempt bonds issued by state and local governments? Will the market in tax-exempts shrink and isn't the cost for these issuers going to go up?

In order to maintain profitability, a bank must look to the after tax rate of return on its investments. Therefore, if banks are unable to deduct their carrying costs, they must increase the rate or move out of tax-exempts and into taxable securities. This could mean that tax-exempt rates will go up. However, the full impact depends on whether others will take the place of banks in the tax-exempt market. This is hard to predict since there are so many provisions included in H.R. 3838 that will affect the tax-exempt market.

2) Recently, Treasury Secretary Baker urged American banks to make new loans to the primary debtor nations. However, it appears that H.R. 3838 would discourage bank participation in such lending. Will the change in the House bill reducing the foreign tax credit for cross-border lending make the banks reluctant to participate in Secretary Baker's initiative? Is there any reason to believe that the banks will in fact be encouraged to pull out of the Baker initiative and out of lending agreements because of this provision? How would the competitive position of U.S. banks be affected if this provision is adopted?

We cannot help but speculate that the limitation on the foreign tax credit for gross withholding taxes will discourage individual banks from participating in Treasury Secretary Baker's initiative for increased foreign lending. We find it ironic that even though Treasury wants to see increased foreign lending, they support a provision which is a disincentive to this very goal.

If the foreign tax credit is not available or is severely limited, U.S. banks would potentially have to increase rates for these loans to remain profitable. This increased cost would put U.S. Banks at a competitive disadvantage with foreign banks whose costs would not be similarly increased.

3) What will the repeal of the bad debt reserve do to the cost of credit for all corporate and individual borrowers? As I understand it, the bad debt reserve provision would require the banks to take into income the existing amount that is paid into their bad debt reserve. What effect on the banks' retained earnings will the provisions have which requires the existing bad debt reserves to be taken into income over five years? Won't it have the effect of reducing the retained earnings of the bank, which then would lead to a reduction in the amount that the bank would add to its capital every year? If in fact there is a reduction in the capital, or at least a reduction in the amount that the capital would otherwise be increased, won't that lead to a reduction in lending?

Rather than enact provisions such as this, should't we be seeking ways to encourage banks to increase their capital to ensure the safety and soundness of financial institutions?

The proposal would require that the tax bad debt reserves be taken into income over a period of five years. In addition, it is likely that the provision for loan losses charged to earnings will exceed the deductible amount. Due to recent accounting pronouncements by the FDIC and Comptroller of the Currency, a bank which is in a position of prepaying its taxes may be required to charge off those prepayments against retained earnings.

The net effect will be, as your question indicates, the reduction of a bank's lending capacity. While the impact of this change on interest rates cannot be predicted because of the numerous other factors involved, it is clear it will act as an unnecessary drag on the economy.

We agree that the repeal of the deduction for loan loss reserves does not support sound banking policy. We believe that any tax reform legislation must be looked at from all sides rather than just from the tax revenue aspect.

4) Many banking experts are concerned about H.R. 3838's treatment of bad debt reserves and the safety of the banking system. Why do you think the Treasury Department proposed changing the tax treatment of bad debt reserves?

It is very difficult to understand the logic used by Treasury in making this proposal. One of the reasons the Treasury gives is that the "...current tax system encourages lenders to make risky loans". This is analogous to saying a lender will risk losing one dollar on a bad loan in order to get thirty-six cents in tax benefits. We don't believe business decisions are made on this basis.

The Treasury also opposed the reserve because "...the lower effective tax rate resulting from excess bad debt deductions subsidizes loans from depository institutions and enables them to offer loans at artificially low rates". Actually, for the most part, loan interest rates are based on market conditions which include the cost of funds to the institution, although the credit worthiness of the customer is also considered. Treasury's statement that the rates are artificially low implies that interest rates should be raised. This is inconsistent with the Federal policy of trying to keep interest rates down.

5) Does the banking industry have billions of dollars on reserve with the Federal Reserve Board? Can banks earn any profits on those reserves? Are banks taxed on these reserves? With regard to banks with foreign operations, on average, what percentage of their income do they pay in foreign taxes? What would be the effect of eliminating this deduction on the safety and soundness of these institutions and their ability to compete with foreign lenders in the current financial environment? Do foreign banks with operations in the United States pay federal taxes? If so, what, on average, is their real or effective tax rate?

The average deposits maintained with the Federal Reserve Bank for 1984 was $21.6 billion. No interest is earned on these deposits. Since no income is earned on the reserves there is no applicable Federal Income Tax. We do not have statistics on foreign taxes for all banks with foreign operations. However, the Joint Committee on Taxation's 1983 Effective Tax Rate Study stated that the cumulative amount of foreign taxes paid by the twenty largest banks was 21.4 percent of their total worldwide income. Again, this represents only twenty banks and therefore does not take into consideration all banks with foreign operations.

The foreign tax credit is the mechanism which is used to avoid double taxation on the same income. Without this credit, lending rates would have to increase in order to maintain profitability. If this is done, U.S. banks may price themselves out of the market.

Foreign banks are subject to U.S. income tax on income earned in the U.S.. We do not have any data on the effective tax rates of foreign banks.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM

B. F. BACKLUND

BANKING/TAX HEARING February 5, 1986

Answers to the written questions of Senator John Heinz

QUESTION 1: Could each of you list, from most onerous to least onerous, which provisions of H.R. 3838 would be most detrimental to you and which you would least like the Senate to adopt?

Most Onerous

1. Repeal of the special net operating carryover rules for financial institutions.
2. Denial of the deduction for the cost of carrying tax-exempt bonds.
3. Linkage of the permissible amount of IRA contributions to the permissible amount of other tax deferred savings plans.
4. Continuation of the tax-exempt status of credit unions.
5. Partial repeal of deduction for loan loss reserves.
6. Partial repeal of cash accounting.

The most onerous provision actually contained in H.R. 3838 is the repeal of the special net operating loss carryover (NOL) provisions for financial institutions. Current law allows financial institutions to carry losses back as far as ten years. H.R. 3838 would allow banks only a three year carryback period.

The NOL rules are essential to the safety and soundness of the banking system, particularly in the Farm Belt. As we noted in our testimony, these banks lend heavily in their localities and therefore often have a large exposure to a single economic sector that predominates in their region. When such a sector experiences an economic downturn, it can mean extraordinary losses for many banks in that region. Without sufficient tax carrybacks, these losses can cause a bank to fail by reducing its capital below the regulators' minimum acceptable level.

The cost of liquidating or selling these banks would far exceed the revenue that the government stands to earn by repealing this provision. The Ways and Means Committee report to H.R. 3838 claims that the repeal of the ten-year carryback rule for banks would bring in less than $5 million dollars per year for the first five years. This amount of revenue is negligible; indeed, the deposit insurance funds may end up losing more than $5 million dollars per year as a result of increased bank failures.

The provision denying banks a deduction for interest attributable to their tax-exempt bond portfolio is also extremely onerous to the banking community. It will discourage banks from holding these securities and drive issuer costs up to prohibitive levels. Many rural towns and counties depend upon their local community banks as purchasers of their bond issues. Without the bank market, bond issuers would undoubtedly have to offer higher rates to attract other buyers or the bonds might never be issued at all.

H.R. 3838 also severely limits the availability of IRA accounts to certain taxpayers. The bill provides that any contribution to a 401K plan will be a direct offset to the amount of money a taxpayer can put in his or her IRA. In other words, after $2,000 is contributed to a 401K plan, no money can be placed in an IRA. The IBAA opposes this limitation. As we noted in our testimony, the issue of taxation of fringe benefits should be kept separate and distinct from individual savings devices such as IRAs.

Although most IBAA member banks were exempted from the House bill's loan loss provisions, the most onerous thing that tax "reform" can do to the financial services industry would be to restrict or repeal the loan loss reserve deduction for banks. This deduction is essential to the safety and soundness of the banking system in America. H.R. 3838 retains current law for all banks with under $500 million in assets. Although the IBAA supports a higher percentage deduction for all banks, it can accept the "small bank exemption" contained in the House bill.

Finally, all banks should be able to continue using cash, rather than accrual, accounting for tax reporting purposes. H.R. 3838 permits banks with less than $5 million in "gross profits" to continue using the cash method. This small bank exemption would include most small banks in the country. The IBAA would sharply oppose any efforts to eliminate this exemption.

QUESTION 2: Which provisions could you live with?

ANSWER: The IBAA can live with the loan loss reserve deduction and the cash accounting provisions, provided that they contain an exemption for small banks. The IBAA could also live with the tax-exempt provision if it contained a similar small bank exemption or if the "small issue exemption" were made permanent.

QUESTION 3: It has been alleged that the largest banks in our country pay little or no taxes. That is very hard to explain to other taxpayers. Could you explain to me why your rates are so low? Also, could you provide me with estimated costs--both in dollar figures and in percentage of income--to you and the banking industry as a whole of these "other costs" that make your tax rates look so low?

ANSWER: The IBAA represents community banks whose average size is approximately $25 million in assets. Community banks have always paid their fair share of taxes. Last year, we asked Sheshunoff & Co., a bank consultant firm, to compute the effective tax rates for all domestic banks with under $5 billion in assets. Their study indicates that the smallest banks in the country pay an effective tax rate of over 30%. The table below shows effective tax rates for the year 1983:

Size of Bank Deposits	Number of Banks in Category	Average Effective Tax
0-9 Million	2102	33.9%
10-24 Million	4392	22.7%
25-99 Million	6025	18.4%
100-499 Million	1549	13.8%
500-999 Million	186	13.6%
1-5 Billion	167	14.9%

As you can see, the effective tax rate declines as the size of the bank increases. The Finance Committee should take care that it distinguishes between the effective tax rates paid by small and large banks when it considers tax reform legislation.

To some degree, the House Ways and Means Committee tried to do this. As noted earlier, H.R. 3838 contains a small bank exemption for the loan loss reserve and the cash accounting provisions in the bill. We strongly urge that a similar exemption be added to the denial of a deduction for carrying tax-exempt bonds and to the repeal of the special NOL rules. Small banks generally buy bonds to help their communities--not to lower their effective tax rates. Small banks that use these special NOL rules are usually fighting to stay afloat in the face of large one-time losses. Repeal of these provisions for small banks will hurt rural communities more than it will help the U.S.Treasury.

QUESTION 4: It is unlikely that your industry will go untouched. We have heard how you will be hurt by the House-adopted tax reform provisions, but what can you offer in their places? Do you have any alternatives?

ANSWER: If Congress needs to raise additional revenue, one suggestion which the IBAA has advocated for many years would be to bring the taxes paid by savings & loans and credit unions more into line with the taxes paid by commercial banks. As for substantive ways to improve the tax treatment of loan loss reserves, the IBAA supports Senator Roth's bill to permit deductions based on the reserves that a bank actually books. This "book-tax conformity" method more accurately reflects the true level of income of a bank, without having to estimate loan losses based on prior years' experience.

QUESTION 5: You have provided us with speculation and anecdotes about the possible effects of the banking provisions of the House tax bill. Do you have any facts and figures to back up your assertions that our foreign trade, towns and cities and consumer-borrowers will be hurt by the provisions of the House bill?

ANSWER: The facts, and figures I can offer you paint a picture that demands extreme caution. It is a picture of America's financial system undergoing deep-rooted change and immense stress. In 1985, over 120 banks failed, a post-Depression record. Over 1,100 banks are on the FDIC's problem list, another post-Depression record. The exposure of the American banking system to "sovereign loans" by LDC borrowers is growing every year, even as the debtor nations' ability to pay is shrinking along with the price of oil. Finally, banks are experiencing direct competition from non-banking firms that have stolen into the financial service arena by the side door marked "non-bank bank loophole." These new players are not regulated by traditional banking laws devised to protect the safety and soundness of the industry. Thus, while competing directly with banks, they operate outside the banking laws.

As for specific facts and figures on the impact these tax proposals will have on various segments of the economy, the IBAA will continue to share whatever relevant information it has with the Committee.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM
B.F.BACKLUND

QUESTION 1: I am concerned with the provision of H.R. 3838 that totally eliminates deductions of the interest expense to carry tax-exempt securities, mainly bonds. If Congress adopts the elimination of the interest expense deduction, what will be the effect on the bank's ability to purchase or trade in tax-exempt bonds issued by state and local governments? Will the market in tax-exempts shrink and isn't the cost for these issuers going to go up?

ANSWER: If Congress eliminates the deduction for carrying tax-exempt securities, the bank market for such issues, especially in rural communities, will shrink to a fraction of its present size. As the tax-exempt status of this type of investment has slowly been reduced (85% in 1982, then 80% in 1984), banks are already beginning to pull out of the market. If this exemption is decreased to zero, it will obliterate the bank market for municipals.

If banks were to cease investing heavily in municipal securities, small town and county issuers would be hard hit. Banks are currently the largest institutional investor in the municipal bond market. Banks provide much of the needed liquidity in the market. By eliminating bank demand for municipals, this liquidity will diminish significantly. Other classes of investors will then have to invest in what would be a much more illiquid type of security. This, in turn, will cause the interest costs of these communities to rise and result in higher state and local taxes.

Costs to municipalities will also rise due to the inability of banks to use municipal securities as collateral for their purchased funds. Generally, all public deposits require collateralization with governmental obligations. Many institutions "match off" these purchased funds with municipals since it is not economical to invest in the Treasury or Agency market (because of the high rates paid for public funds). If these purchased funds held by banks cannot be invested at a profit (i.e. with municipals), then the rates they offer to localities will drop. This, in turn, could have the effect of causing state and local governments to invest their funds elsewhere as they seek higher returns. The resulting disintermediation will put strains on an already fragile banking system. The end result is an increase in the cost of credit for state and local governments.

QUESTION 2: Recently, Treasury Secretary Baker urged American banks to make new loans to the primary debtor nations. However, it appears that H.R. 3838 would discourage bank participation in such lending. Will the change in the House bill reducing the foreign tax credit for cross-border lending make the banks reluctant to participate in Secretary Baker's initiative? Is there any reason to believe that the banks will in fact be encouraged to pull out of the Baker initiative and out of lending agreements because of this provision? How would the competitive position of U.S. banks be affected if this provision is adopted?

ANSWER: The IBAA is not in a position to be able to respond to these foreign tax issues.

QUESTION 3: What will the repeal of the bad debt reserve do to the cost of credit for all corporate and individual borrowers? As I understand it, the bad debt reserve provisions would require the banks to take into income the existing amount that is paid into their bad debt reserve. What effect on the banks' retained earnings will the provision have which requires the existing bad debt reserves to be taken into income over five years? Won't it have the effect of reducing the retained earnings of the bank, which then would lead to a reduction in the amount that the bank would add to its capital every year? If in fact there is a reduction in the capital, or at least a reduction in the amount that the capital would otherwise be increased, won't that lead to a reduction in lending?

ANSWER: The analysis contained in Question 3 is basically correct. The Congress should be looking for ways to increase bank capital. The Congress should enact S. 1263, introduced by Senator Roth which provides that banks could deduct the amount of money actually set aside in its loan loss reserve. This so-called "book-tax conformity" method eliminates the system whereby a separate tax account must be created for loan loss reserves. Book-tax conformity is thus simpler. The bill also contains an upper limit for the deduction of 1.5% of eligible loans, which is significantly better than current law but still less than the 1.8% level set in 1975.

QUESTION 4: Many banking experts are concerned about H.R. 3838's treatment of bad debt reserves and the safety of the banking system. Why do you think the Treasury Department proposed changing the tax treatment of bad debt reserves?

ANSWER: The IBAA and other banking trade associations have communicated their concerns to the Treasury on many occasions. The Treasury recommendations were probably a result of a desire to eliminate the present system of tax "expenditures" and to create a system free of tax incentives. The Treasury Department, however, in its search to reduce tax expenditures, has simply made a mistake by treating loan loss reserves for financial institutions the same as loss reserves of other types of businesses. By doing this, Treasury has totally ignored the unique role that loan loss reserves serve in financial institutions. They are not a tax shelter or loophole, but are demanded by government regulation and sound banking practice. By this proposal, the Treasury Department has recommended revenue-raising measures that could have disastrous long-term effects on the banking industry.

QUESTION 5: Does the banking industry have billions of dollars on reserve with the Federal Reserve Board? Can banks earn any profits on those reserves? Are banks taxed on these reserves? With regard to banks with foreign operations, on average, what percentage of their income do they pay in foreign taxes? What would be the effect of eliminating this deduction on the safety and soundness of these institutions and their ability to compete with foreign lenders in the current financial environment? Do foreign banks with operations in the United States pay federal taxes? If so, what, on average, is their real or effective tax rate?

ANSWER: All financial institutions maintain reserves with the Federal Reserve System. These reserves are held at the Fed in non-interest bearing accounts. Banks do not earn any income on these funds and therefore pay no income tax. However, there is a price to be paid--the banks' foregone interest on these funds is an implicit cost or "tax" to the banks. In fairness to banks, this should be considered in computing their effective tax rates.

Since the IBAA represents only smaller banks with little or no foreign operations, we are not in a position to comment on the effect that repeal of the loan loss reserve deduction would have on foreign competition.

RESPONSE TO WRITTEN QUESTIONS OF SENATORS HEINZ AND D'AMATO

FROM J. THOMAS MACY

AICPA

American Institute of Certified Public Accountants
1620 Eye Street, N. W., Washington, D. C. 20006 (202) 872-8190

February 13, 1986

Senator Jake Garn
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Senator Garn:

I am writing to respond to your letter of February 6th which followed up on the Committee's recent hearing and which enclosed additional questions from Senators D'Amato and Heinz concerning the impact of the House tax bill on banking.

Most of the questions asked by Senators D'Amato and Heinz are best answered by representatives of financial institutions and their trade associations rather than the American Institute of Certified Public Accountants, on whose behalf I testified. There are two issues raised, however, in Senator D'Amato's questions to which I believe I can appropriately respond, since they relate to a portion of my testimony.

Senator D'Amato asks "Why do you think the Treasury Department proposed changing the tax treatment of bad debt reserves?" According to the General Explanation contained in the President's Tax Proposals, issued in May, 1985, the Treasury views the deduction for bad debt reserve additions as a deduction for future loan losses. This fundamental misunderstanding of the nature and function of the loan loss reserve, I believe, led to the proposal. I would invite the Committee's attention to the discussion of income measurement on pages 4 and 5 of my written testimony. To summarize, rather than providing a current tax year deduction for a future tax year loss, the reserve method results in the proper measurement of economic income because it recognizes *current* losses currently rather than deferring them to the future.

Senator D'Amato also asks about the impact of the proposed repeal of the loan loss reserve deduction, and the taxation of previously deducted additions to loan loss reserves, on bank capital and the safety and soundness of financial institutions. I welcome the opportunity to discuss this point further because it is an important point and because it appears to have been neglected in other public discussions of this issue.

In order to reflect fairly the current losses inherent in loan portfolios, banks have been increasing loan loss reserves faster for financial statement purposes than allowed for tax purposes, at least since 1982. This has created a prepaid tax item rather than a deferred tax item. In other words, taxable income has been overstated in years prior to the actual charge-off, resulting in the prepayment of taxes relative to the recognition of income.

Because the prepaid tax items can be offset against deferred tax items (for example, accelerated depreciation), the problem created by this growing prepaid tax item has developed slowly and quietly. Within the last year the problem has grown more rapidly and become more acute. In addition, both the FDIC and the OCC have, within the past year, issued guidance to banks requiring them, in certain circumstances, to charge the net prepayment as a reduction in earnings, and therefore, as a reduction of capital. The issue is under active consideration by the Financial Accounting Standards Board as well.

This issue is tied directly to safety and soundness because an important element in the assessment of the safety and soundness of a bank is the level of its capital. Capital includes the loan loss reserve. Enactment of the House tax bill may well result in a reduction of bank capital for two reasons:

> First, as previously discussed, net tax prepayments may have to be charged to capital. These prepayments will increase significantly when previously deducted loan loss reserves are reversed back into taxable income -- as would be required by the House bill.

> Second, by making increases in loan loss reserves a nondeductible cost of carrying on the banking business, the House bill erects a real economic disincentive to making such increases. This is part of the concern, no doubt, expressed by FDIC Chairman Seidman, when he made his comment about the conflict between the Treasury -- working very hard to take away the deduction -- and Federal bank regulatory agencies who are working very hard to increase reserves for the soundness and stability of the system.

I appreciate the opportunity to comment further on this important issue and would be pleased to discuss it further with you, other members of the Committee, or staff. I would like also to take this opportunity to reiterate my recommendation that you undertake, with your Committee, to work to preserve the loan loss reserve deduction for commercial banks and to change current law to employ the book/tax conformity method of determining the deduction. The problem I have described will remain, although temporarily diminished in certain instances, if current law only is preserved.

Very truly yours,

J. Thomas Macy

J. Thomas Macy

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM
WALTER V. SHIPLEY

Introductory Statement Walter V. Shipley:

I am attaching a copy of the oral testimony which I presented to the Senate Banking Committee on February 5. I believe this testimony is responsive to several of the questions and I will therefore refer to it where appropriate. I appeared before the Senate Banking Committee in my capacity as Chairman of the Clearing House Committee of the New York Clearing House Association, which organization approved the attached testimony. Because the New York Clearing House has not been asked to approve responses to certain of the questions raised, I am unable to respond to all questions.

Questions From Senator Heinz

Q. 1) Could each of you list, from most onerous to least onerous, which provisions of HR 3838 would be most detrimental to you and which you would least like the Senate to adopt?

Q. 2) Which provisions could you live with?

Answer to
Questions 1 and 2:

The first four pages of my testimony explained why the New York Clearing House has strong objections to the H.R. 3838 provisions impacting the loan loss reserve and foreign tax credit areas and why we would urge the Senate to reject these provisions. In my testimony, I pointed out that the New York Clearing House would support provisions when the effect is to achieve increased fairness, equity and simplicity in our federal tax laws, such as the provisions providing for reductions in tax rates and elimination of numerous tax brackets.

Q. 3) It has been alleged that the largest banks in our country pay little or no taxes. That is very hard to explain to other taxpayers. Could you explain to me why your rates are so low? Also, could you provide me with estimated costs -- both in dollar figures and in percentage of income -- to you and the banking industry as a whole of these "other costs" that make your tax rates look so low?

Q. 4) It is unlikely that your industry will go untouched. We have heard how you will be hurt by the House-adopted tax reform provisions, but what can you offer in their places? Do you have any alternatives?

Answer to
Questions 3 & 4:

Elimination of the reserve method of accounting for loan losses would make our federal tax laws inconsistent with the goals of the banking regulators who have been advocating increases in bank loan loss reserves in order to enhance the safety and soundness of the banking system and the individual capital positions of each banking institution. Elimination of the loan loss reserve method would reduce retained earnings of banks and would greatly diminish the incentives to build the capital position of banks. The New York Clearing House would support the comments made by the American Bankers Association and the AICPA on this subject of loan loss reserves during their February 5 testimony before your committee. In particular the New York Clearing House joins the ABA in strong support of Senate Bill 1263, which would permit banks a loan loss reserve for tax purposes equal to the reserve reflected for financial accounting purposes.

Q. 4) You have provided us with speculation and anecdotes about the possible effects of the banking provisions of the House tax bill. Do you have any facts and figures to back up your assertions that our foreign trade, towns and cities and consumer-borrowers will be hurt by the provisions of the House bill?

Answer to
Question 5:

U.S. banks are required by law to maintain billions of dollars of non-interest bearing reserves with the Federal Reserve System. The Fed earns interest on these reserves, and after payment of relatively minor amounts of expenses, turns over the proceeds to the U.S. Treasury just as any other form of tax. In this case the check in payment of the federal tax is written by the Federal Reserve System but the burden of the tax is borne by the banking industry. For example, during 1985 Chemical Bank maintained average reserve balances with the Federal Reserve System of $475 million dollars. When the Federal Reserve's average 1985 rate on all assets of about 8% is applied to these reserves, this results in an implicit tax imposed on Chemical Bank of $39 million dollars. Speaking for Chemical Bank, I would be quite happy to receive interest on these reserves and pay federal income taxes on such interest income.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM
WALTER V. SHIPLEY

Q. 1. I am concerned with the provision of H.R. 3838 that totally eliminates deductions of the interest expense to carry tax-exempt securities, mainly bonds. If Congress adopts the elimination of the interest expense deduction, what will be the effect on the bank's ability to purchase or trade in tax-exempt bonds issued by state and local governments? Will the market in tax-exempts shrink and isn't the cost for these issuers going to go up?

Answer to
Question 1:

Because this subject was not addressed in my February 5 testimony, I will defer to the other members of the first panel. However, as I pointed out in response to an oral question from Senator D'Amato, the elimination of the cost of carry deduction for banks will clearly cause a significant increase in the borrowing costs of states and cities. Any change in this area must be done on a prospective basis only, such as by providing that the new provisions would apply only to exempt obligations "issued after" a certain date, to avoid disruption in the marketplace.

Q. 2. Recently, Treasury Secretary Baker urged American banks to make new loans to the primary debtor nations. However, it appears that H.R. 3838 would discourage bank participation in such lending. Will the change in the House bill reducing the foreign tax credit for cross-border lending make the banks reluctant to participate in Secretary Baker's initiative? Is there any reason to believe that the banks will in fact be encouraged to pull out of the Baker initiative and out of lending agreements because of this provision? How would the competitive position of U.S. banks be affected if this provision is adopted?

Answer to
Question 2:

On page 4 of my testimony, I pointed out that the foreign tax provisions of H.R. 3838 create disincentives to lending to less developed countries on the part of U.S. banks at a time when Treasury Secretary Baker is encouraging support from governments and financial institutions around the world. I further pointed out that the H.R. 3838 foreign withholding tax provisions would result in decreased availability of foreign tax credits to U.S. banks. U.S. banks would therefore have to charge a higher rate of interest in order to earn the same yield as their foreign bank competitors. In many cases U.S. banks are unable to charge higher rates of interest because they are competing with foreign banks whose home countries' tax laws, capital requirements, loan loss treatment and treaty networks already give them a competive advantage over their U.S. counterparts.

Q 3. What will the repeal of the bad debt reserve do to the cost of credit for all corporate and individual borrowers? As I understand it, the bad debt reserve provision would require the banks to take into income the existing amount that is paid into their bad debt reserve. What effect on the banks' retained earnings will the provision have which requires the existing bad debt reserves to be taken into income over five years? Won't it have the effect of reducing the retained earnings of the bank, which then would lead to a reduction in the amount that the bank would add to its capital every year? If in fact there is a reduction in the capital, or at least a reduction in the amount that the capital would otherwise be increased, won't that lead to a reduction in lending?

Rather than enact provisions such as this, shouldn't we be seeking ways to encourage banks to increase their capital to ensure the safety and soundness of financial institutions?

Answer to
Question 3:

It appears that several of the H.R. 3838 provisions are aimed at the banking industry because of this erroneous perception that banks pay little or no taxes. Pages 5 and 6 of my testimony point out that banks pay a great deal of taxes to federal, foreign, and state and local governments, when those taxes are properly measured to include the indirect taxes attributable to our non-interest bearing Federal Reserve deposits and municipal obligations.

Page 4
D'Amato

Q. 4. Many banking experts are concerned about H.R. 3838's treatment of bad debt reserves and the safety of the banking system. Why do you think the Treasury Department proposed changing the tax treatment of bad debt reserves?

Answer to
Question 4:

We do not believe it would be appropriate for the New York Clearing House to instruct Congress how to raise revenue. Rather, we were invited to comment on the impact of H.R. 3838 on the banking industry and in so doing we pointed out those provisions that do not promote fairness, equity or simplicity when applied to the banking industry. I should point out that several H.R. 3838 provisions, such as the elimination of the investment tax credit and the changes in allowable methods of depreciation, raise considerable revenue from the banking industry.

Q. 5. Does the banking industry have billions of dollars on reserve with the Federal Reserve Board? Can banks earn any profits on those reserves? Are banks taxed on these reserves? With regard to banks with foreign operations, on average, what percentage of their income do they pay in foreign taxes? What would be the effect of eliminating this deduction on the safety and soundness of these institutions and their ability to compete with foreign lenders in the current financial environment? Do foreign banks with operations in the United States pay federal taxes? If so, what, on average, is their real or effective tax rate?

Answer to
Question 5:

Our testimony was not based upon speculation and anecdotes, but rather represented facts and the experience of our members. Our testimony explained how the H.R. 3838 foreign withholding tax provisions would result in decreased ability of U.S. banks to finance exports into several marketplaces, resulting in a worsening of the U.S. balance of trade and a decline in U.S. employment. In this regard, we note that George J. Clarke representing the National Foreign Trade Council and Charles H. Miller, III, representing the Bankers Association for Foreign Trade presented excellent testimony on this point on February 4 and 5 respectively and we would endorse the comments made by these two gentlemen on this subject.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM

CHARLES H. MILLER, III

1) You state that under the foreign tax provisions of HR 3838 U.S. banks could not extend competitive financing in support of U.S. exporters. This will obviously result in less financing of exports by U.S. banks, but will this result in fewer total exports? Do you have any figures on that? What dollar figure has been placed on the losses U.S. banks would face under these provisions? Is there an estimate of the resulting tax loss to our Treasury if U.S. banks lose this source of income?

2) How do our existing foreign tax laws compare with our foreign competitors' tax laws and how would these new provisions compare? You claim we would be less competitive under HR 3838, would our lack of competitiveness be the result of our new tax laws or because of unfair tax laws imposed on American banks in foreign countries? Do you feel foreign countries treat U.S. banks fairly?

February 14, 1986

The Honorable Jake Garn, Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
SD 534 Dirksen Senate Office Building
Washington DC 20510

Dear Senator Garn:

The Bankers' Association for Foreign Trade appreciated the opportunity to testify before the Senate Banking Committee at its recent hearings on H.R. 3838, the Tax Reform Act. Although we were unable to meet the February 11 deadline stated in your letter of February 6 we have attempted in the limited time allowed to address the questions posed by Senators Heinz, D'Amato and Sasser.

Regarding Senator Heinz's request for quantitative data on the negative economic effects of the foreign tax provisions of HR 3838 both on U.S. exports and on the dollar losses that U.S. banks will sustain under this provision, I regret to say that there is no econometric data available at this time. With respect to the question of how our existing foreign tax laws compare with those of our foreign competitors I am pleased to note that the subject is being addressed by a major accounting firm in a study that will be released shortly.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM
CHARLES H. MILLER, III

1. The foreign tax provisions contained in H.R. 3838, (Sec. 621) currently pending before the Senate Finance Committee, include a repeal of tax deferral for U.S. banking and other financial service industries. What is your position with respect to this proposal?

2. Do you believe that the U.S. Internal Revenue Code should take a consistent position on tax deferral with regard to both manufacturing and financial services industries, or is there a rationale for treating these sectors differently?

3. There have been allegations that U.S. individuals have utilized the existing subpart "F" exclusion for banking and financial service income to avoid paying their fair share of U.S. taxes. Would you agree with this statement? Can you suggest how this situation could be stopped?

4. Would a blanket repeal of the Subpart "F" exclusion for financial services income affect, in your judgment, the competitiveness of U.S. financial institutions operating in international financial markets?

Answer:

BAFT does not presently have a position on Senator D'Amato's questions regarding the proposed changes in tax deferral contained in Section 621 of the Tax Reform Act. However, we do understand that the recommended changes pose problems for banking institutions.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SASSER FROM
CHARLES H. MILLER, III

I am particularly concerned about the implications H.R. 3838 may have on the ability of our banks to finance the exports of our regional and national U.S. customers.

* Exactly what impact do you think the proposed changes to the foreign tax credit and loan loss requirements in H.R. 3838 will have on the ability of U.S. banks to finance U.S. exports in the highly competitive international markets?

Last week The Wall Street Journal reported that "After conquering large sections of the world market for manufactured goods, the Japanese now are on their way to becoming the world's bankers."

Separately, I am told that shortly after World War II U.S. banks held 50% of the assets of the world's 100 largest banks and by the end of 1983 they held only 14%.

* What is happening with respect to the international competitiveness of American banks and what effect would passage of H.R. 3838 have on our competitiveness?

Answer: I believe that our written testimony, a copy of which is attached, addresses Senator Sasser's questions on the current competitive position of U.S. banks and the competitive effect that passage of H.R. 3838 will have on U.S. banks. Exhibit A illustrates both graphically and numerically that U.S. banks have lost market share to foreign competition and now rank second to Japanese banks in international markets. Pages 3-6 and page 9 of our testimony explain the negative competitive impact that Section 602 of the Tax Reform Act will have on U.S. banks.

Should you or anyone on your staff wish to further discuss these issues we would be pleased to meet with you.

Sincerely yours,

M. Condeelis
Executive Director

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM

JOE MORRIS

U.S. League of Savings Institutions
to Questions from Senator D'Amato
Following our Testimony Before the
Senate Banking Committee on the Impact of H.R. 3838

Q. 1. What will the effect of H.R. 3838 be on the cost to the FSLIC for the sale of savings and loans under assisted mergers?

A.1. H.R. 3838 will at least double the cost to the FSLIC of merging troubled thrift institutions. The House bill repeals Section 597 of the internal revenue code on January 1, 1986 which excuses basis adjustment for FSLIC assistance and exempts FSLIC payments to troubled thrifts from taxation. Therefore, FSLIC will now have to pay 4 or more dollars of assistance for every 3 dollars they paid when such payments were tax exempt.

The repeal of another special provision Sec. 368(a)(3)(D) allowing for tax-free reorganizations of troubled thrifts will create an even bigger cost to the FSLIC where there was no cost before. With all mergers and acquisitions becoming taxable after January 1, 1986, FSLIC would now be faced with either liquidating the troubled thrift, indemnifying the acquiring institution for its reorganization losses, or just paying the tax on the reorganization transaction. (All of these options are expensive especially liquidation which is the most expensive method of resolving troubled thrift cases). FSLIC will now pay hard dollars for reorganizations which were previously tax exempt.

Q. 2. (a) H.R. 3838 eliminates the special rules for net operating losses of depository institutions, beginning January 1, 1986, and applies the general corporate carry forward rules to thrifts. What would be the effect of this provision upon thrift institutions that have exhausted their carryback periods and are now carrying forward a large portion of their net operating losses if H.R. 3838 were enacted into law?

A.2a. If H.R. 3838 were enacted into law, all thrift losses incurred after January 1, 1986 would be eligible for a fifteen-year carry forward. However, thrift losses still outstanding from the early 1980s would expire for the most part since they are only eligible for a five-year carryforward. The amount of losses projected to expire is approximately $13 billion. This large buildup of NOLs is a result of the enormous interest rate losses suffered by our industry during the early 1980s. Most thrift institutions have already exhausted their NOL carrybacks leaving the carryforward as the only way to utilize these remaining thrift losses. Present law allows only a 5-year carryforward which forces institutions with large losses from the early 1980s to suffer substantial NOL expiration because they cannot return to profitability quickly enough to utilize these old losses.

Q. 2. (b) At present thrift institutions have a 15-year carryforward period consisting of a 10-year carryback and a 5-year carryforward. Due to the recent losses experienced by the thrift institutions since 1981, should the net operating loss carryforward provisions be increased? If so, how long should this time period be? Would the extension of the net operating loss carryforward assist the FSLIC in arranging mergers of troubled institutions? How would this be accomplished?

A.2b. Thrift net operating losses to a large extent will expire under the current 10-year carryback and 5-year carryforward rules. Most thrifts have already exhausted their carrybacks and are looking to carryforward their losses to offset current income. Unfortunately, carryforwards never help unless you are profitable and the 5-year rule doesn't provide enough time for most of our big loss institutions to return to profitability. Consequently, thrift carryforward rules should be increased to allow write-off of some existing losses against future thrift income. The longer the carryforward extension the better. However, the savings industry realizing that revenue loss is an important consideration has unanimously adopted a politically acceptable extension of three additional carryforward years for losses incurred from 1981 through 1985. A Price-Waterhouse Study based upon a U.S. League Industry Survey indicates that only a small portion of those losses that would otherwise expire in 1986 and 1987 can be used when the 3-year NOL extension is granted. The Price-Waterhouse Study shows that a three-year NOL extension would preserve about $970 million in net operating losses that would otherwise expire. In rough terms, 36 percent of $970 million is equal to a $350 million revenue loss. Applying the graduated rate structure and the thrift method bad debt deduction reduces this revenue loss to approximately $300 million for this selective 3-year NOL extension.

A three-year extension for net-operating losses is not unprecedented especially when major NOL changes are proposed. Thus in 1981 when normal corporations were granted 15-year NOL carryforward and 3-year carryback, Congress provided that existing losses back to 1976 could be treated under the new rules and granted a 15-year carryforward. Thus, the three-year carryforward transition rule we've proposed is nowhere near as generous as the 1981 law granted ordinary corporations.

The additional three-year carryforward should help FSLIC in arranging mergers of troubled thrifts because it provides an additional tax benefit to attract acquiring institutions. The more unexpired losses, the better are FSLIC chances to locate a takeover candidate.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM KENNETH F.X. ALBERS

National Council of Savings Institutions

Response to Questions from Senator D'Amato

QUESTION:

1. What will the effect of H.R. 3838 be on the cost to the FSLIC for the sale of savings and loan under assisted mergers?

ANSWER:

The effect of provisions contained in H.R. 3838 will be to substantially increase the cost to the FSLIC for the sale of savings and loans under assisted mergers.

Under current law, FSLIC assistance granted in supervisory merger cases is tax free to the acquiring institution. In addition, certain rules regarding "continuity of interest" are modified in assisted mergers so that a tax free reorganization or merger can occur. This modification allows the surviving entity to use certain tax benefits such as net operating loss carryovers of the failing institution to offset income.

This tax treatment offers economic benefit to a potential acquiror of a failed thrift which may lower the "price" or dollar amount of assistance that must be given by FSLIC in order to interest potential acquirors. While tax considerations are not the only criteria potential bidders may base bids on, they certainly are an important part of the process. Repeal of these favorable tax provisions will certainly raise the up front dollar assistance which must be given by FSLIC if a merger is to be consumated. Or, in some cases, lack of the incentives will mean no merger partner can be found. This would require the FSLIC to liquidate institutions which is a much more expensive solution to the problem.

QUESTION:

2.a. H.R. 3838 eliminates the special rules for net operating losses of depository institutions, beginning January 1, 1986, and applies the general corporate carryforward rules to thrifts. What would be the effect of this provision upon thrift institutions that have exhausted their carryback periods and are now carrying forward a large portion of their net operating losses if H.R. 3838 were enacted into law?

ANSWER:

The modifications of the carryover provisions contained in H.R. 3838 would have no effect on current losses which are being carried forward for 5 years. The provisions repealing the special carryover provisions for thrifts (10 back/5 forward) and allowing the 3 year carryback/15 year carryforward given to other corporations would only be effective for losses incurred after December 31, 1985. Thus, the provision would not assist thrifts in dealing with the substantial net operating losses incurred in the economic upheavals of the early 1980's which will expire unused over the next 2-5 years.

RESPONSES TO QUESTIONS FROM SENATOR D'AMATO

QUESTION:

2.b. At present thrift institutions have a 15 year carryforward period consisting of a 10 year carryback and a 5 year carryforward. Due to the recent losses experienced by the thrift institutions since 1981, should the net operating loss carryforward porvisions be increased? If so, how long should this time period be? Would the extension of the net operating loss carryforward assist the FSLIC in arranging mergers of troubled institutions? How would this be accomplished?

ANSWER:

Yes, the net operating loss carryforward period for losses incurred from 1981 through 1985 should be extended to allow use of these extraordinary net operating losses. We believe an extension of the current 5 year net operating loss carryforward period to 8 years would accomodate most of the losses.

The extension of the net operating loss carryforward period would assist institutions by reducing their tax burden as they restructure and rebuild capital. It will also allow some institutions to remain viable and return to profitability. Finally it would assist FSLIC and FDIC in arranging mergers of troubled institutions. Allowing acquiring institutions to use these net operating losses of acquired institutions to offset income for tax purposes, provides some economic benefit which lowers the cost of supervisory mergers to the depository insurance agencies.

IMPLICATIONS OF H.R. 3838, THE TAX REFORM ACT

THURSDAY, FEBRUARY 6, 1986

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 9 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, D'Amato, Gorton, Mattingly, Hecht, Cranston, Riegle, Dixon, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The Chairman. The Banking Committee will come to order.

We have a large number of witnesses today, 17, so we will proceed as rapidly as possible and I would ask each of the witnesses if they could summarize their comments in the interest of time and we will, of course, put your entire statements in the record.

Today the committee continues with the third of 3 days of hearings on the House-passed tax bill, H.R. 3838. Today's hearing focuses on the bill's impact on State and local governments and the housing industry.

The committee appreciates the willingness of each of today's witnesses to testify. Because there will be 17 witnesses, however, we would remind each of you to limit your remarks to as close to 5 minutes as possible. This is less time than the committee normally permits, but it is necessary to do this in order for the committee to hear equally from everyone.

In addition to your testimony today, we ask that you respond by next week to any written questions submitted for the record. We recognize that this is a short turnaround period, but in order for the committee's report to be useful to the Finance Committee, we must complete it as soon as possible.

We have also requested statements for the record from those organizations that are unable to testify today.

Mr. Guthman, if you would like to begin, please.

STATEMENT OF RICHARD GUTHMAN, COUNCIL MEMBER, ATLANTA, GA, ON BEHALF OF THE NATIONAL LEAGUE OF CITIES

Mr. Guthman. Thank you, Mr. Chairman. My name is Richard Guthman. I am a member of the Atlanta City Council and here today representing the National League of Cities.

The league represents directly and indirectly some 15,000 municipalities of all sizes throughout the Nation. It is the oldest and largest organization representing local elected officials—most of whom, like myself, hold a full-time position in the private sector, and use what we refer to affectionately spare time to serve in public office.

I am grateful for this opportunity to testify this morning with regard to the impact of Rosty II, H.R. 3838, on the Nation's cities.

Even though we have been advised by staff of the Senate Finance Committee that the committee intends to ignore this committee's hearings and any findings thereon, we believe your efforts are critical to a better understanding of the potential impacts on public policy issues under this committee's jurisdiction.

The CHAIRMAN. Could I interrupt you at that point? The Senate Finance Committee staff told you that, that they intended to ignore us?

Mr. GUTHMAN. That's my understanding, yes.

The CHAIRMAN. Well, I'll guarantee you, they will not ignore us. We recognize that we have no jurisdiction. We are only doing this for information purposes and I am sure that is not the attitude of the members, and the staff can be ignored if that is their attitude. Please continue.

Mr. GUTHMAN. Thank you, Mr. Chairman.

UNCERTAINTY OF FUNDING LEVELS CREATES PROBLEMS

As I speak to you this morning, it is an extraordinary time for city leaders. Even though the Federal fiscal year is nearly half over, and the fiscal year for most municipalities is nearly three-quarters over; city elected officials still have no idea what the fiscal year 1986 funding levels are for key city programs, what traditional public purpose bonds may be issued retroactive to January 1 of this year, or what new Federal mandates will be imposed retroactively.

What we do know is that these issues are in no way separable. As we face Gramm-Rudman and new Federal mandates, including those incorporated as part of tax reform, any Federal action which intrudes upon our authority to raise our own revenues will exacerbate our ability to provide not only basic public services, but also the housing and infrastructure critical to community and economic development.

In 1985, Federal tax policy clearly became the dominant factor in shaping and setting Federal urban or municipal policy. According to the OMB, Senate Budget Committee, and House Budget Committee, Federal tax expenditures far outstrip direct Federal expenditures to the Nation's cities. For the first time in history, the Internal Revenue Service has become the single most critical agency from our perspective with regard to issues ranging from housing and community development, to unemployment and job training, to infrastructure and environment, and even to municipal health insurance and police cars. Moreover, the correlation between the phenomenal growth in Federal tax expenditures and the Federal deficit has not escaped us. Nor has it escaped us that the two congressional committees that negotiated the Gramm-Rudman law exempted the majority of their expenditures. It makes it easier for us to understand the effort to attempt to say that deficit reduction and tax reform are not related.

We do not agree, and we support the efforts of Senators Dole, Domenici, and Boschwitz to make sure that a responsible and accountable budget resolution is adopted before the Senate proceeds with Federal tax reform.

In housing and community development alone we have seen an enormous change since 1979. Today the Federal Government expends more in Federal assistance as it affects our record deficit, but the source has completely changed. As you can see, Senator, from this chart in my statement, starting in 1979—and unfortunately this is not in color, but the white bars or blue, those were direct assistance, and the dark or red were tax expenditures. As you can see, in 1979, the direct assistance was around $40 million and the tax expenditures was around $28 million, but when you go into 1986, direct assistance has fallen to around $11 and tax expenditures have risen to $67 million.

We have increasingly during this period gone to the Treasury to seek input on Federal housing, community, and economic policy as it affects us. Time and again, we are informed that it is the Treasury's job to collect taxes—not to set housing and urban development policy.

Yet, in the Congress and the administration we have watched the growth in back door spending—spending which avoids the budget, authorization, and appropriations process. Federal tax expenditures are now the largest and fastest growing part of the Federal budget, and the ones subject to the least policy and budget scrutiny.

Consequently, and once again, Mr. Chairman, we congratulate you for your concern and interest in holding these hearings.

Neither the administration proposal nor Rosty II approach simplicity. Fairness, of course, is in the eye of the beholder.

Overall, our analysis is that Rosty II or the President's proposal would have a massive impact on the Nation's cities. That impact may not, however, be measured in common terms, for no two cities would be affected the same way. Because cities are simply a sum of individuals and corporations, it is the sum of the impact of the changes—particularly the major corporate tax changes—which will affect each and every city. Obviously, some would be winners, some would be losers depending upon the types of corporate constituents within our respective borders.

Having said that, however, and proceeding from the basis that the Senate Finance Committee has repudiated both the President's tax reform proposal and Rosty II, I would like to raise two fundamental issues which would adversely impact all municipalities.

PROPOSAL TO REPEAL DEDUCTIBILITY OF STATE TAXES

The President proposed to repeal the deductibility of all State and local taxes. According to the Treasury, this would reduce municipal revenues 1 to 3 percent. At a time when the Federal Government has made repeated deep cuts in basic domestic assistance programs, and at a time when States and local governments have repeatedly increased local taxes to assume new responsibilities, we are ill-equipped to have the Federal Government undercut our own capacity and authority to raise our own tax revenues.

This proposal is particularly troubling now as we attempt to anticipate Gramm-Rudman, the extraordinary deferrals in community development block grants [CDBG], and the administration's budget.

Cities have simply been hammered, and the effects have become especially harsh in some parts of the country. In the small municipalities in the farm sector, property assessments have been plummeting. In southern Texas, the combination of falling oil prices, illegal immigration, and the devaluation of the peso has caused extraordinary fiscal distress. In a growing number of States, municipalities are restricted from raising taxes. In Iowa alone, 47 percent of cities with populations over 500 are at their general fund limit; yet the Governor has called for an across-the-board cut in all State aid to cities and a property tax freeze.

Without question, any action by the Senate to undercut our own ability to raise local revenues will be severe. In any year we would oppose it; this year we have no choice.

I must add, Mr. Chairman, that some suggestions have been made with regard to a partial repeal. Chairman Packwood, for instance, intimated that a majority of his committee were prepared to repeal the deductibility of sales taxes.

As you know, there are no sales taxes in Oregon, while they are the greatest source of revenue in Utah. We believe it would be discriminatory and inequitable for the Federal Government to make any changes, especially any which would set a discriminatory imprimatur on one kind of municipal tax over another.

The new restrictions and mandates on the authority to issue notes and bonds takes up some 148 pages in Rosty II. Although the House bill is a very substantial improvement over the administration's proposal, it has already caused a severe erosion in municipal authority to issue even general obligation and revenue bonds, while sharply increasing the cost. Rosty II has simply closed the door on the authority of the city of Atlanta, all other municipalities in Georgia, and the State to issue any tax-exempt bond. The State of Georgia today is engaged in its legislative session debating its budget. It has $400 million worth of general obligation bonds. It wishes to include the debt service in that budget and it's stalled because of the retroactive provision that is now in the bill. It simply does not know what to do.

Across the Nation, Rosty II has reduced the volume of revenue bonds to finance public school construction, highway and prison construction, and water and sewers by 82 percent from January 1985. It has reduced the issuance of general obligation bonds backed by the full faith and credit of the issuing government by 55 percent. It has increased the cost of those issues that can go to market by 25 basis points.

It has slammed the door on housing bonds completely. It has raised questions with regard to tax increment financing bonds retroactive to July 18, 1984—bonds for redevelopment under State law secured 100 percent by property taxes.

First, how is it that this bill, not even considered by the Senate, can already have such a devastating impact?

Before any municipal bond is issued, legal counsel provides an opinion as to whether the interest paid on the bonds will be taxable to the purchaser or holder. Because Rosty II contains an effective date of January 1, 1986, bond counsel now must advise any holder that the interest might be taxable, in effect placing a cloud on our authority and ability to issue the bonds. I have included an example to illustrate my point, which is a proposed tombstone ad that would appear in any paper when bonds are issued.

The one on the left would be what would be the normal way of doing it. It would say this general obligation bond, in the opinion of counsel, the interest of which is tax free. On the one on the right, which is what they have to say now, they have a full paragraph of legal mumbo jumbo which says, in essence, you're probably buying a taxable—the interest is going to be taxable.

TAXING MUNICIPAL BONDS

As originally proposed, the President's tax reform proposal would have stated that any bond would become taxable if more than 1 percent of the proceeds benefited any nongovernmental person, directly or indirectly. Under that proposal, virtually every municipally owned and operated EPA mandated wastewater treatment facility in the country would have been ineligible for tax-exempt financing, every airport, every public transportation system, all single and multifamily housing, and most public hospitals and schools. Even Secretary Baker agreed with us last summer that that proposal was simply unreasonable.

Nevertheless, Rosty II retains the idea of restricting the definition of traditional public purpose. Indeed, initially as reported out of the Ways and Means Committee, Rosty II divided bonds into governmental and nongovernmental. It was only when legislative counsel advised the committee staff that Federal law could not define municipally owned and operated facilities as nongovernmental that the committee changed its categories into essential and nonessential.

Under Rosty II a bond is deemed essential if no more than 10 percent or $10 million benefits a nongovernmental user.

This means, for instance, that the use of an incentive management contract for a public transit system owned and operated by a city would make the bonds issued for construction retroactively taxable.

It means that the use of a municipal facility as a shelter for the homeless under the auspices of a church would make the bonds issued for the facility retroactively taxable.

It means that major public hospitals which must accept any patient, regardless of the ability to pay, would be ineligible for tax-exempt financing.

I call your attention to a little cartoon on that page which attempts to show the impact of the proposed changes on the State volume caps and all the complications that basically municipally owned and operated facilities which fail this rule are literally left out in the cold.

There has been a steady drumbeat of privatization—somehow, it has been postulated that if cities privatize, we can accommodate Federal cuts without tax increases or service cuts. Our own city has just this week approved the leasing of our golf courses where we can do it better, but under the proposal now that would mean that our golf courses, which we own, would be ineligible for any general obligation bonds that would be tax exempt. But the administration and Rosty II bills disproportionately penalize any city which contracts out, as we just have, whether for emergency room service, for housing management, or for child care.

We know of no reason for this extraordinary change and restriction on our capacity to raise short- and long-term funds to meet basic and traditional municipal needs, but we do know the impact, coming on top of everything else, has been major.

Even, Mr. Chairman, where one sighs relief at meeting the new essential test, there is more to come.

If the equivalent of more than $1 million in bond proceeds benefits any nongovernmental user, the excess must be allocated for under a new State-by-State volume cap or the bonds become taxable.

Even if you meet that test too, one must make sure that at least 5 percent of the proceeds are spent within 30 days of issuance. In my State, the constitution prohibits awarding any public contract—or for that matter, any obligations of money—until the money actually is in hand.

But from your past experience, you well remember the difficulties of acquiring the right-of-ways and beginning construction always on schedule. I try and imagine what would happen if we applied that 5 percent rule to the Pentagon.

And finally, even if we get past that hurdle and the rebate and new accounting on arbitrage restrictions, we face a whole new problem with the market: Who can buy or will buy our bonds?

For the House bill basically removes my profession—the banking profession—from the short- and long-term market. It removes the insurance industry.

That means the cost will go up, and I can tell you already that the cost to borrow have gone up substantially, several hundred basis points, 400 basis points, that I know of, because of some of the new restrictions which are presumably retroactive—especially for short-term financing, especially for smaller cities—and I emphasize especially for small cities that have not had previous access to the public market. It will cause a significant change in traditional relationships between cities and their bankers.

Rosty II allows municipalities to issue nonessential bonds under a new volume cap if they are in one of the 11 eligible categories. Included in those categories are several of great importance to us and to this committee: Single and multifamily housing bonds, mass commuting facility bonds, and tax increment financing bonds.

Tax increment financing bonds may be issued, subject to a State's volume cap, if it meets not only State law but a number of new retroactive restrictions in Federal law, including a new requirement that the designated redevelopment area must exceed one-quarter square mile but may not exceed 10 percent of the assessed property value of a city. Now in a small city, do you see how that could possibly work?

I know, Mr. Chairman, that you set up the redevelopment authority in Salt Lake City when you were mayor, and brought your former director to this committee. Thus, I know you are more likely to be familiar than most Members of the Senate as to how vital a public tool tax increment financing is for redeveloping blighted downtown areas, especially given the deep cuts in CDBG and urban development action grants [UDAG].

REDUCTION IN LOW-INCOME HOUSING

With regard to housing, I believe your efforts, along with those of the others on this committee, were critical in preserving the authority of cities and States to raise capital for low-income housing and rehabilitation in 1980. This time around, Rosty II preserves some authority, but under a much reduced volume cap and more stringent requirements.

Moreover, Rosty II, by stretching out the depreciation for bond financed housing, has reduced the incentive for developers to set aside low-income units. I believe the intent of the Ways and Means Committee to preserve incentives for the production and rehabilitation of low- and moderate-income housing by cities is praiseworthy, but the results fail.

Certainly, I believe this committee could make significant contributions to ensure that any tax reform process on the Senate has this committee's policy experience and input, and the National League of Cities would be pleased to provide any assistance you would like as part of that effort.

Mr. Chairman, I thank you very much for this opportunity to testify and I would be happy to answer any questions that you might have.

The **Chairman**. Thank you very much. We appreciate your willingness to testify on behalf of the cities of the country and I certainly do understand the problem. It surprises me greatly that there would be such a lack of understanding in the House, because many of the people who voted for these provisions that have such a dramatic impact on municipal financing at least think they are great defenders of the city. They will fight for many other programs, such as programs that are recommended to be cut in the budget, but apparently they have no comprehension whatsoever of what they are doing by fouling, to put it bluntly, the whole municipal financing market.

Mr. **Guthman**. Mr. Chairman, we agree, but it also is amazing to us how the administration on the one hand could promote certain activities such as privatization, to which I think is good, and then on the other hand promote policies and proposals that would destroy that very thing which they promote. That is just totally amazing to us.

It may be amazing to everybody, not just to us.

The **Chairman**. Well, I won't repeat my speech of yesterday. Everybody who was here knows how I feel about the whole House-passed bill. But referring to this particular part of it, some of the same people in the administration and in the House of Representatives who are also so worried about how regressive property taxes are don't seem to understand the connection between causing these problems in the municipal bond market and where those higher interest rates are going to be paid from—increased property taxes. There is virtually no other source of income. Certainly in my State property tax is virtually the whole source of income. We get a half a cent local option sales tax or a quarter of a cent, and we've got building fees and a few supplementary sources of revenue, but basically we ran my city and others on the property tax. So that's exactly where the tax burden is going to fall.

Now somehow we've got to do a much better job. As to my immediate response to your comments about the Finance Committee staff, I meant it. Ignore staff. We have to do that a lot around here, and I would suggest the mayors of this country start contacting every Congressman and every Senator. They can ignore staff and they can even ignore the Finance Committee by going directly to the membership, and they should be informed of the impact this will have on the cities, counties, and States in this country. And if that's what they want to vote for when they know and understand the problem, fine. Then we can count their votes and check on them at the election, but this would have a dramatic impact.

I floated enough bond issues when I was mayor and participated in the sale of those to know what the situation is, and H.R. 3838's provisions are not comprehensible to me at all in light of the problems many cities in this country are having.

So I suggest the National League of Cities gear up as we know you can do. I've been involved with that organization in the past. And start concentrating on every individual member, just in case they do want to ignore your testimony that comes before this committee or the Finance Committee. They can't ignore their individual county and city and State organizations. So gear up the troops over there.

Mr. GUTHMAN. I would say that we are in a mobilization stance, Mr. Chairman. I appreciate that. I will leave also with the committee, our tabulation of the volume cap on nongovernmental bonds State-by-State under Rosty II, as well as how all the various tax plans, including the current law, compare for your information.

[The complete prepared statement follows:]

STATEMENT OF
MR. RICHARD GUTHMAN
COUNCIL MEMBER, ATLANTA, GEORGIA

on behalf of
THE NATIONAL LEAGUE OF CITIES

on
IMPACT OF FEDERAL TAX REFORM
ON ISSUES UNDER THE JURISDICTION
OF THE
U.S. SENATE BANKING COMMITTEE

before the
COMMITTEE ON BANKING
UNITED STATES SENATE

February 6, 1986

Mr. Chairman, and members of the Committee, good morning. My name is Richard Guthman. I am a member of the Atlanta City Council and here today representing the National League of Cities.

The League represents directly and indirectly some 15000 municipalities of all sizes throughout the nation. It is the oldest and largest organization representing local elected officials - most of whom, like myself, hold a full time position in the private sector, and use our "spare" time to serve in public office.

I am grateful for the opportunity to testify this morning with regard to the impact of Rosty II, HR 3838, on the nation's cities.

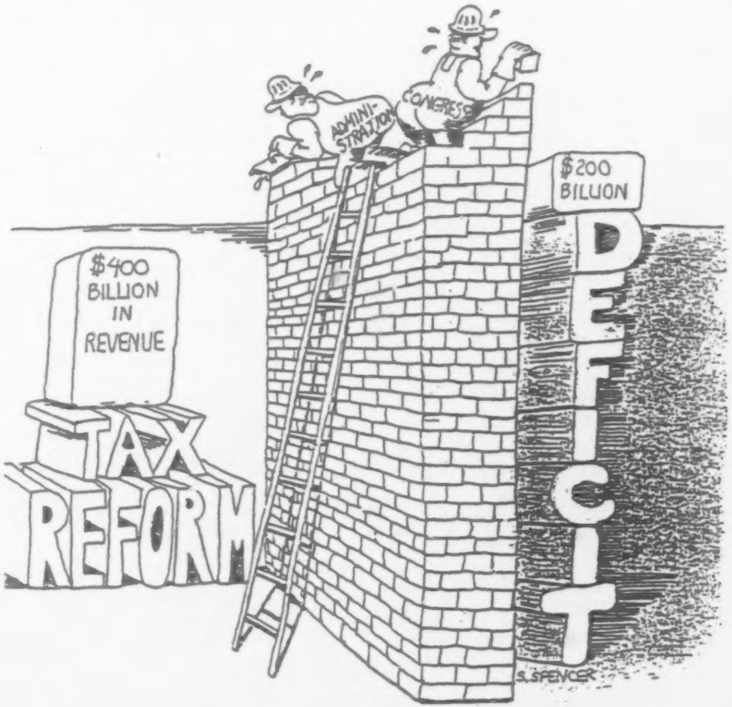
Even though we have been advised by staff of the Senate Finance Committee that the committee intends to ignore this committee's hearings and any findings thereon, we believe your efforts are critical to a better understanding of the potential impacts on public policy issues under this committee's jursidiction.

As I speak to you this morning, it is an extraordinary time for city leaders. Even though the federal fiscal year is nearly half over, and the fiscal year for most municipalities is nearly three-quarters over; city elected officials still have no idea what the FY1986 funding levels are for key city programs, what traditional public purpose bonds may be issued retroactive to January 1st of this year, or what new federal mandates will be imposed retroactively.

What we do know is that these issues are in no way separable. As we face Gramm-Rudman and new federal mandates, including those incorporated as part of tax reform, any federal action which intrudes upon our authority to raise our own revenues will exacerbate our ability to provide not only basic public services, but also the housing and infrastructure critical to community and economic development.

In 1985, federal tax policy clearly became the dominant factor in shaping and setting federal urban or municipal policy. According to the OMB, Senate Budget Committee, and House Budget Committee, federal tax expenditures far outstrip direct federal expenditures to the nation's cities. For the first time in history, the Internal Revenue Service has become the single most critical agency from our perspective with regard to issues ranging from housing and community development, to unemployment and job training, to infrastructure and environment, and even to municipal health insurance and police cars. Moreover, the correlation between the phenomenal growth in federal tax expenditures and the federal deficit has not escaped us. Nor has it escaped us that the two Congressional Committees that negotiated the Gramm-Rudman law exempted the majority of their expenditures. It makes it easier for us to understand the effort to attempt to say that deficit reduction and tax reform are not related.

We do not agree, and we support the efforts of Senators Dole, Domenici, and Boschwitz to make sure that a responsible and accountable budget resolution is adopted before the Senate proceeds with federal tax reform.



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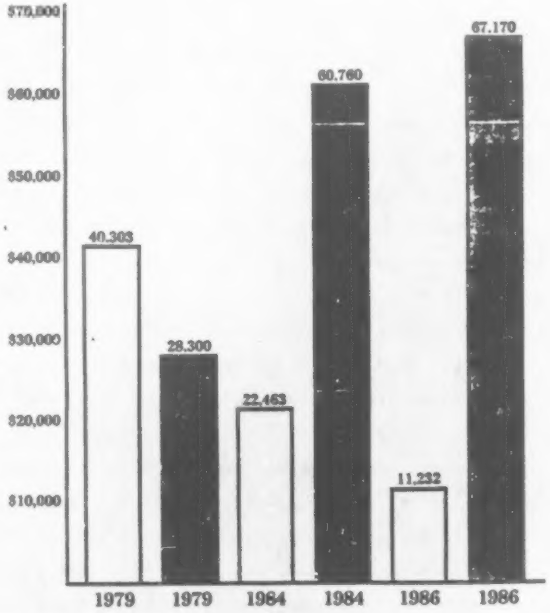

HOUSING AND COMMUNITY DEVELOPMENT

Blue-Direct Assistance
Red-Tax Expenditures
(in millions)

NATIONAL LEAGUE OF CITIES

We have - increasingly during this period, gone to the Treasury to seek input on federal housing, community, and economic policy as it effects us. Time and again, we are informed that it is the Treasury's job to collect taxes - not to set housing and urban development policy.

Yet, in the Congress and the administration we have watched the growth in back door spending - spending which avoids the budget, authorization, and appropriations process. Federal tax expenditures are now the largest and fastest growing part of the federal budget, and the ones subject to the least policy and budget scrutiny.

Consequently, and once again, Mr. Chairman, we congratulate you for your concern and interest in holding these hearings.

Tax Reform & Cities

Neither the administration proposal, nor Rosty II approach "simplicity." Fairness, of course, is in the eyes of the beholder.

Overall, our analysis is that Rosty II or the president's proposal would have a massive impact on the nation's cities. That impact may not, however, be measured in common terms: for no two cities would be affected the same way. Because cities are simply a sum of individuals and corporations, it is the sum of the impact of the changes - particularly the major corporate tax changes - which will affect each and every city. Obviously, some would be winners, some would be losers depending upon the types of corporate constituents within our respective borders.

Having said that, however, and proceeding from the basis that the Senate Finance Committee has repudiated both the President's tax reform proposal and Rosty II, I would like to raise two fundamental issues which would adversely impact all municipalities.

Deductibility of State and Local Taxes:

The President proposed to repeal the deductibility of all state and local taxes. According to the Treasury, this would reduce municipal revenues 1-3 percent. At a time when the federal government has made repeated deep cuts in basic domestic assistance programs, and at a time when states and local governments have repeatedly increased local taxes to assume new responsibilities, we are ill-equipped to have the federal government undercut our own capacity and authority to raise our own tax revenues.

This proposal is particularly troubling now as we attempt to anticipate Gramm-Rudman, the extraordinary deferrals in CDBG, and the administration's budget.

Cities have simply been hammered, and the effects have become especially harsh in some parts of the country. In the small municipalities in the farm sector, property assessments have been plummeting. In southern Texas, the combination of falling oil prices, illegal immigration, and the devaluation of the peso has caused extraordinary fiscal distress. In a growing number of states, municipalities are restricted from raising taxes in Iowa alone 47 percent of cities with populations over 500 are at their general fund limit; yet the Governor has called for an across the board cut in all state aid to cities and a property tax freeze.

Without question, any action by the Senate to undercut our own ability to raise local revenues will be severe. In any year we would oppose it; this year we have no choice.

I must add, Mr. Chairman, that some suggestions have been made with regard to a partial repeal. Chairman Packwood, for instance intimated that a majority of his committee were prepared to repeal the deductibility of sales taxes.

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Municipal Bonds:

The new restrictions and mandates on the authority to issue notes and bonds takes up some 148 pages in Rosty II. Although the House bill is a very substantial improvement over the administration's proposal, it has already caused a severe erosion in municipal authority to issue even general obligation and revenue bonds, while sharply increasing the cost.Rosty II has simply closed the door on the authority of the City of Atlanta, all other municipalities in Georgia, and the state to issue any tax exempt bond.

Across the nation, Rosty II has reduced the volume of revenue bonds to finance public school construction, highway and prison construction, and water and sewers by 82 % from January of 1985. It has reduced the issuance of general obligation bonds backed by the full faith and credit of the issuing government by 55%. It has increased the cost of those issues that can go to market by 25 basis points.

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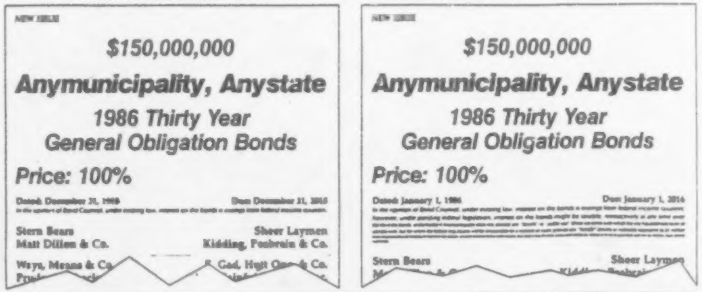
First, how is it that this bill, not even considered by the Senate can already have such a devastating impact?

Before any municipal bond is issued, counsel provides an opinion as to whether the interest paid on the bonds will be taxable to the purchasor or holder. Because Rosty II contains an effective date of January 1, 1986, bond counsel now must advise any holder that the interest might be taxable, in effect placing a cloud on our authority and ability to issue the bonds. I have included an example to illustrate my point:

The bond market tombstones—before and after Rosty II



NEW ISSUE
$150,000,000
Anymunicipality, Anystate
1986 Thirty Year
General Obligation Bonds
Price: 100%
Dated: December 31, 1985
Due December 31, 2015
Stern Bears
Matt Dillon & Co.
Ways, Means & Co.
Sheer Laymen
Kidding, Poobrain & Co.
E. Gad, Hgt Ow & Co.
NEW ISSUE
$150,000,000
Anymunicipality, Anystate
1986 Thirty Year
General Obligation Bonds
Price: 100%
Dated: January 1, 1986
Due: January 1, 2016
Stern Bears
Sheer Laymen

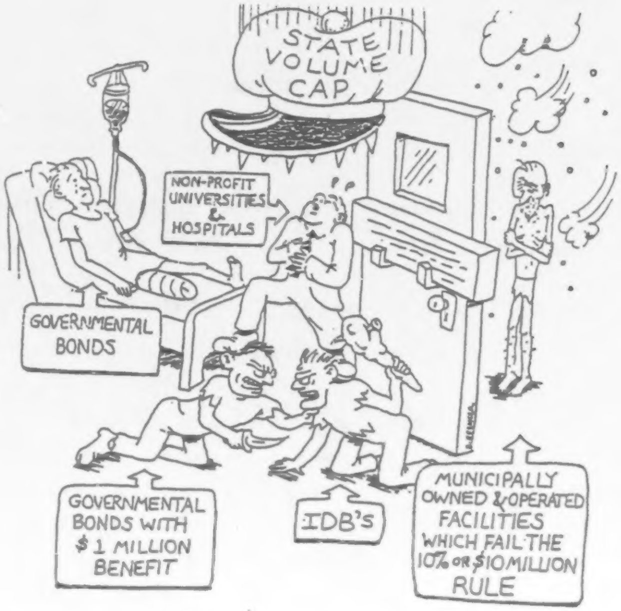
Restrictions on traditional public purpose bonds:

As originally proposed, the President's tax reform proposal would have stated that any bond would become taxable if more than 1% of the proceeds benefitted any non-governmental person, directly or indirectly. Under that proposal, virtually every municipally owned and operated EPA mandated wastewater treatment facility in the country would have been ineligible for tax exempt financing, every airport, every public transportation system, all single and multifamily housing, and most public hospitals and schools. Secretary Baker agreed with us last summer that the proposal was simply unreasonable.

Nevertheless, Rosty II retains the idea of restricting the definition of traditional public purpose. Indeed, initially as reported out of the Ways and Means Committee, Rosty II divided bonds into "governmental" and "non-governmental". It was only when legislative counsel advised the committee staff that federal law could not define municipally owned and operated facilities as "non-governmental" that the committee changed its categories into "essential" and "non-essential".

Under Rosty II a bond is deemed "essential" if no more than 10% or $10 million benefits a non-governmental user.

This means, for instance, that the use of an incentive management contract for a public transit system owned and operated by a city would make the bonds issued for construction retroactively taxable.


STATE VOLUME CAP
NON-PROFIT UNIVERSITIES & HOSPITALS
GOVERNMENTAL BONDS
GOVERNMENTAL BONDS WITH $1 MILLION BENEFIT
IDB'S
MUNICIPALLY OWNED & OPERATED FACILITIES WHICH FAIL THE 10% OR $10 MILLION RULE

It means that the use of a municipal facility as a shelter for the homeless under the auspices of a church would make the bonds issued for the facility retroactively taxable.

It means that major public hospitals which must accept any patient, regardless of the ability to pay, would be ineligible for tax exempt financing.

There has been a steady drumbeat of privatization - somehow, it has been postulated that if cities privatize, we can accomodate federal cuts without tax increases or service cuts. But the administration and Rosty II bills disproportionately penalize any city which contracts out - whether for emergency room service, for housing management, or for child care.

We know of no reason for this extraordinary change and restriction on our capacity to raise short term and long term funds to meet basic and traditional municipal needs, but we do know the impact, coming on top of everything else, has been major.

Even, Mr. Chairman, where one sighs relief at meeting the new "essential" test, there is more to come.

If the equivalent of more than $1 million in bond proceeds benefits any non-governmental user, the excess must be allocated for under a new state-by-state volume cap - or the bonds become taxable.

Even if you meet that test too, one must make sure that at least 5% of the proceeds are spent within 30 days of issuance. In my state, the constitution prohibits awarding any public contract until the money is in hand.

But from your past experience, you well remember the difficulties of acquiring the right-of-ways and beginning construction always on schedule. I try and imagine what would happen if we applied the 5% to the Pentagon...

And finally, even if we can get past that hurdle and the rebate and new accounting on arbitrage restrictions, we face a whole new problem at the market: who can buy our bonds?

For the House bill basically removes my profession - the banking profession - from the short term and long term market. It removes the insurance industry.

That means the cost will go up - especially for short term financing, especially for smaller cities that have not had previous access to the public market. It will cause a significant change in traditional relationships between cities and their bankers.

Rosty II allows municipalities to issue "non-essential" bonds under a new volume cap if they are in one of the 11 eligible categories. Included in those categories are several of great importance to us and to this committee: single and multifamily housing bonds, mass commuting facility bonds, and tax increment financing bonds.

Tax increment financing bonds may be issued - subject to a state's volume cap - if it meets not only state law, but a number of new retroactive restrictions in federal law, including a new requirement that the designated redevlopment area must exceed one quarter square mile, but may not exceed 10 percent of the assessed property value of a city.

I know, Mr. Chairman, that you set up the redevelopment authority in Salt Lake when you were mayor, and brought your former director to this committee. Thus, I know you are more likely to be familiar than most members of the Senate as to how vital a public tool tax increment financing is for redeveloping blighted downtown areas - especially given the deep cuts in CDBG and UDAG.

With regard to housing, I believe your efforts, along with those of the other old-timers on this committee, were critical in preserving the authority of cities and states to raise capital for low income housing and rehabilitation in 1980. This time around, Rosty II preserves some authority, but under a much reduced volume cap and more stringent requirements.

Moreover, Rosty II, by stretching out the depreciation for bond financed housing, has reduced the incentive for developers to set aside low income units. I believe the intent of the Ways and Means Committee to preserve incentives for the production and rehabilitation of low and moderate income housing by cities is praiseworthy, but the results fail.

Certainly, I believe this committee could make significant contributions to ensure that any tax reform process on the Senate has this committee's policy experience and input - and the National League of Cities would be pleased to provide any assistance you would like as part of that effort.

I thank you for the opportunity to testify, and I would be happy to answer any questions you might have.

ROSTY II: VOLUME CAP ON NON-GOVERNMENTAL BONDS
(in millions)

	Student Loan Bonds	Exempt Entity Bonds	Small Issue and Industrial Park	Sewage Disposal and Waste	Total MRBs, Vets and MF IDBs Issued in State CY 1984	Total	$175 per Capita With $200 Million Floor	Cap as % of 1984 Activity
Total	$1,680	$10,055	$16,951	$6,561	$20,361	$55,608	$42,111	132%
Alabama	—	338	365	55	202	960	702	137%
Alaska	—	—	89	—	1,467	1,556	200	778%
Arizona	—	319	318	402	224	1,263	512	247%
Arkansas	—	44	102	29	110	285	410	70%
California	426	783	492	552	4,214	6,467	4,424	146%
Colorado	—	246	218	20	333	817	545	150%
Connecticut	—	79	203	35	306	623	564	111%
Delaware	—	8	134	—	53	195	200	98%
Florida	12	748	541	1,002	944	3,247	1,864	174%
Georgia	—	31	745	524	325	1,625	1,009	161%
Hawaii	—	82	—	—	100	182	200	91%
Idaho	37	5	18	—	56	116	200	58%
Illinois	132	477	728	38	519	1,894	2,048	93%
Indiana	—	315	357	87	203	962	979	98%
Iowa	11	4	186	—	215	416	520	80%
Kansas	—	38	178	100	207	523	431	121%
Kentucky	41	113	218	61	209	642	656	98%
Louisiana	196	195	406	198	315	1,310	781	168%
Maine	—	—	60	—	108	168	203	83%
Maryland	14	164	561	—	653	1,392	763	182%
Massachusetts	122	506	503	112	316	1,559	1,034	151%
Michigan	—	248	631	426	186	1,491	1,630	92%
Minnesota	60	78	585	172	395	1,290	740	174%
Mississippi	—	42	111	149	203	505	456	111%
Missouri	—	357	383	61	336	1,137	886	128%
Montana	68	26	59	13	75	241	200	121%
Nebraska	—	116	110	—	235	461	284	162%
Nevada	—	9	21	—	222	252	200	126%
New Hampshire	5	45	90	15	72	227	200	114%
New Jersey	—	252	1,009	293	366	1,920	1,331	144%
New Mexico	—	13	59	—	115	187	243	77%
New York	—	1,004	1,149	174	679	3,006	3,160	95%
North Carolina	—	38	349	9	163	559	1,077	52%
North Dakota	128	27	20	19	75	269	200	135%
Ohio	—	271	661	42	456	1,430	1,931	74%
Oklahoma	—	3	116	128	288	535	569	94%
Oregon	—	105	78	57	273	513	474	108%
Pennsylvania	200	782	1,480	606	377	3,445	2,123	162%
Rhode Island	—	86	60	210	225	581	200	291%
South Carolina	—	18	301	261	112	692	573	121%
South Dakota	49	23	42	—	200	314	200	157%
Tennessee	—	146	679	—	248	1,073	832	129%
Texas	25	1,447	769	334	2,346	4,921	2,734	180%
Utah	—	—	165	90	251	506	278	182%
Vermont	—	32	72	1	48	153	200	77%
Virginia	88	129	996	234	578	2,025	983	206%
Washington	46	50	100	50	175	421	760	55%
West Virginia	—	61	80	—	209	350	349	100%
Wisconsin	20	152	309	2	300	783	853	92%
Wyoming	—	—	45	—	74	119	200	60%

*NOTE: *This chart does not include the portion of governmental bonds (for any amount in excess of $1 million to any non-governmental user) nor those portions of airport or port bonds which would be under the volume cap.*

Sources: U.S. Treasury; NLC

HOW THE TAX PLANS COMPARE

	CURRENT LAW (1986)	NOVEMBER 1984 TREASURY PROPOSAL FOR 1986	PRESIDENT'S PROPOSAL FOR 1986	ROSTY I 1986	ROSTY II 1986
Muncipal Bonds					
"Governmental"	Tax-exempt	1% rule	1% rule	5% rule	10% or $10 million rule
"Nongovernmental"					
Multifamily rental housing bonds	Tax-exempt	Taxable	Taxable	Tax-exempt, capped targeted	Tax-exempt, capped targeted
Single family mortgage revenue bonds	Tax-exempt	Taxable	Taxable	Tax-exempt, capped expire 1987 targeted	Tax-exempt, capped expire 1987 targeted
Small issue idbs	Expire 1986 except for manufacturing	Taxable	Taxable	Taxable	Tax-exempt, capped
Tax increment financing bonds	Tax-exempt	Taxable	Taxable	Taxable	Partially exempted, capped
Airport, docks, wharves	Tax-exempt	Taxable	Taxable	Tax-exempt, capped	Tax-exempt
Water, sewer, solid waste	Tax-exempt	Taxable	Taxable	Tax-exempt, capped	Tax-exempt, capped
Pollution control bonds	Tax-exempt	Taxable	Taxable	Taxable	Taxable
Deductibility of Individual					
Property taxes	Yes	No	No	Yes/modified	Yes
Sales taxes	Yes	No	No	No	Yes
Income taxes	Yes	No	No	Yes/modified	Yes
Personal property taxes	Yes	No	No	No	Yes
Housing Rehabilitation Tax Credit	Yes	No	No	Yes/modified	Yes/modified
Historic Tax Credit	Yes	No	No	Yes/modified	Yes/modified
Targetted Jobs Tax Credit	Yes	No	No	No	Yes/modified
Energy Renewal Conservation Tax Credit	Yes	No	No	No	No
Individual Tax Rates	14 rate brackets from 11 to 50% indexed	3 rate brackets 15, 25, & 35%, indexed	3 rate brackets 15, 25, & 35% indexed	3 rate brackets 15, 15, & 35% indexed	4 rate brackets 15, 15, 35 & 38% indexed
Exemptions					
Self, Spouse	$1,080, indexed	$2,000, indexed	$2,000, indexed	$1,500 for each, indexed,	Non-itemizers $2,000, indexed; itemizers, $1,500 indexed
Dependents	$1,080, indexed	$2,000, indexed	$2,000, indexed	$1,500, indexed	Non-itemizers $2,000, indexed; itemizers, $1,500 indexed
Standard Deductions					
Single	$2,480, indexed	$2,800, indexed	$2,900, indexed	Indexed	$2,950, indexed
Joint	$3,670, indexed	$3,800, indexed	$4,000, indexed	Indexed	$4,800, indexed
Heads of Household	$2,480, indexed	$3,500, indexed	$3,600, indexed	$3,000, not indexed	$4,200, indexed
Earned income credit	Yes, ($540 maximum)	Yes, indexed	Yes, indexed	Yes, indexed	Yes, indexed
Fringe benefits					
Employee provided health insurance	Not taxed	Taxed above a cap, $300 for family	Taxed up to $120 for individual	Taxed	Not taxed
Itemized deduction					
Charitable contributions	Deductible by itemizers and non-itemizers	Deductible (above 2% of Adjusted Gross Income) for itemizers, but no deduction for non-itemizers or for unrealized gains on contributed property	Deductible for itemizers, but no deduction for non-itemizers	Deductible for itemizers, but no deduction for non-itemizers	Deductible, non-itemizers permitted deduction for contributions in excess of $100
Mortgage interest	Deductible	Deductible, for principal residences	Deductible, for principal residences	Deductible for principal residences	Deductible, for principal and second homes
Capital and Business Income					
Corporate tax rates	Graduated, up to 46%	33% flat rate	Graduated, up to 33%	33%	Graduated, up to 36%
Investment tax credit	6%–10%	No	No	No	No
Capital gains	60% excluded	Indexed, taxed as ordinary income in 1991)	50% excluded (optional indexing)	No exclusion; taxed as ordinary income	42% excluded
Financial Institutions					
Deduction for interest to carry tax exempts	Yes	No	No	No	No, except for small cities
Minimum Tax on Individuals and Corporations	Yes	Not necessary	Retain and tighten	Yes, including interest on "non-governmental bonds"	25%, including on "non-governmental bonds"

SOURCES: Office of the Secretary of the Treasury; Sen. Bradley; Rep. Kemp; Ways and Means Committee; NLC.

The CHAIRMAN. Senator Dixon.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the Banking Committee conducts its third day of hearings on the implications of pending tax reform proposals for areas of the committee's jurisdiction. At the outset, I would like to acknowledge a distinguished representative of one of my State's finest hospitals, Leo Henikoff, Jr. of Rush Presbyterian, St. Luke's Medical Center in Chicago, IL. I know the committee will find his comments to be extremely valuable.

As I understand it today's witnesses will focus on the effects of the tax reform proposals on issuers of tax-exempt bonds and on the housing industry. I am not pleased with the changes H.R. 3838 makes in the tax exempt financing area. This area of the law needs some certainty. We just instituted major changes in 1984. I don't see how it is reasonable to come back this quickly with yet another round of changes. Further, given the major spending cuts proposed in the President's budget yesterday, States, municipalities and other tax-exempt bond issuers need this kind of financing even more, since Federal programs are likely to be increasingly unable to help them meet their economic development and other needs.

I also understand the key role a strong housing and real estate sector plays in the American economy. The home building and real estate industries are the foundation of our economy, and we must be certain that tax reform does not undermine their ability to help ensure stable long-term economic growth. I look forward to hearing the witnesses comments on the impacts of tax reform in this area. Tax reform is a failure if it works to undermine the ability of Americans to be able to purchase their own homes.

PROBLEMS STEMMING FROM RETROACTIVE DATE

The CHAIRMAN. I would like you to expand just a little bit for the record on the problems that are occurring simply because of the retroactive date. Some of us in the Senate have been trying very hard to change this date, not only because of this particular problem, but because throughout the entire country everybody is having problems with the uncertainty. I would hope that the Senate and the House could come to agreement on one thing, if nothing else, and that is that the effective date of whatever we do in tax reform would not be until January 1, 1987, so that business and municipalities and everybody alike can plan for 1986.

It seems to me that the uncertainties are almost more difficult to deal with than if we had passed some of the provisions you don't like. At least you would then know how to proceed.

Mr. GUTHMAN. Well, you're absolutely correct, and I would be happy if they would do that. I guess tax law is the only law that would propose with a retroactive date which in effect becomes effective until some conclusion is drawn. As I mentioned earlier, the State of Georgia with the general assembly in session and I think even debating the budget today, within the Governor's budget is a proposed $400 million worth of general obligation bonds which under all circumstances the interest of which would be considered tax free. But in the provision of Rosty II was something that really in the simplified version of 148 pages relating to just bonds alone, there's a little rule that you had to spend 5 percent of the proceeds within 30 days of the sale of bonds. It was little noticed.

That means that, in effect, the State of Georgia, because it cannot even contract with an engineer or an architect to design anything until the bonds are sold and the money is in the bank—that's pretty good prudent fiscal policy, the same with our city. We cannot expend a dime until the money is in the bank. We can't even go out for bids until we know that we have the money in hand for a particular project.

So there is no way, if you're familiar with any kind of government contracting, there is no way you can spend any amount of that money within 30 days unless you buy a postage stamp to mail something.

So these bonds in the whole budget process which anticipated debt service in the budget to fund these projects is now stalled with the idea that the $400 million is going to have to come out directly out of current cash rather than from the bonds. So the budget process is totally destroyed. The whole concept is totally destroyed because if in fact the bill were to pass like it is and those bonds retroactive to January 1, 1986, the interest is going to be taxable. So you cannot sell those bonds at any tax-exempt rate. You could go out on the market and sell them as taxable bonds and all you would do then is cost more to the public, and these are traditional public purpose—there's no privatization, no private benefit per se—if it's not the government's business to build public education facilities, to build public roads, then what is the government's purpose?

The CHAIRMAN. Senator D'Amato.

Senator D'AMATO. Mr. Chairman, I think Mr. Guthman illustrates the problem with H.R. 3838 when he noted the effects of the new 30-day rule. I cannot comprehend why we want to prevent municipalities from making prudent investments while they are going forward with their public projects. I guess if certain Congressmen from down in Texas and their staff want to do everything they can to kill municipal financing, they've done a great job. But I think when the people in Texas find that absolutely necessary projects can't go forward, they can thank the House Ways and Means Committee for passing a bill which harbors an absolute bias against tax-exempt financing.

This bill is so bad that it has the ability, even without being enacted, to push us into a recession in which tens of thousands of people, who would otherwise be gainfully employed in absolutely necessary projects, remain idle because necessary projects have been held up. That's not good for the economy. Ultimately this bill will not save the taxpayers' money and will only drive the cost of those projects up. I find it hard to support tax reform that will cost the taxpayers money. I detect a certain prejudice, bias against and lack of understanding of municipal financing and tax-exempt financing here in this body as well. Maybe not to the same extent as in the House, but it exists. In some cases, it's rather shocking because some of our colleagues who have had experience in local government should realize the impact of this legislation.

I'd like to know how you can find and make a distinction between essential and nonessential bonds, some that come under the cap and some that don't come under the cap; how you can say that sewers should come under the cap but the sewage treatment plant that takes that material should not come under the cap. What logic can be cited to justify allowing an unlimited amount of funds to be expended for sewers while placing sewage treatment plants under a cap? You've got to be a mental midget to decide that when we're talking about cleaning the waters, providing essential services, someone could place arbitrary volume caps on the amount of funds that can be spent to finance public purpose projects by characterizing them as nonessential.

The CHAIRMAN. Senator, are you opposed to the bill?

STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Mildly. I commend you for calling these hearings and focusing in on this. I have another hearing, the Small Business Committee that looks at the impact of this incredible fiasco on small business and who knows what we're going to find there.

I would hope that the League of Cities would wake up and you would really energize them and get them moving because there's a lot of work that has to be done.

I want to welcome our witnesses to the third and perhaps most important hearing that the Banking Committee has held to address the consequences of H.R. 3838, the Tax Reform Act of 1985, on those institutions within the committee's jurisdiction. My position on the tax bill in its present form is no secret. I think the bill is totally unacceptable. It represents a patchwork quilt of compromises that do nothing to promote the goals of true tax reform and simplification. Moreover, H.R. 3838 reverses the thrust of the tax law enacted in 1981. That bill encouraged investment which increased productivity and was vital to the creation of over 9 million new jobs. I don't think we should be prepared to reverse this trend by endorsing H.R. 3838—a bill that totally ignores the economic realities that promote the growth of capital formation. The promotion of capital formation fuels our economy and any impediments to this process will slow economic growth and result in recession rather than expansion. Any legislation, such as this, that potentially leads to recession should be rejected by this body. We should not be stampeded into passage of a bill under the guise of tax reform that will prove so disruptive to our economy.

One of H.R. 3838's most serious shortcomings is its treatment of tax exempt bonds. The consequence of the bill's tax-exempt bond provisions is demonstrated by the drought in this market that has occurred since January 1, 1986, the effective date of H.R. 3838. Since January 1, States and cities have sold only $1.5 billion in new bond issues—the smallest monthly volume since December 1974. The problems H.R. 3838's treatment of tax exempt bonds are compounded by the financial burdens placed upon State and local governments by reductions in revenue sharing programs and other spending cuts resulting from passage of the Gramm-Rudman Act. At a time when these governments are being asked to finance a greater portion of their expenditures, we have effectively denied them their most economic means of raising funds. If they are forced to issue taxable securities at higher rates, then local taxpayers will ultimately have to foot this bill. Such a result can hardly be characterized a tax reform.

The burdens imposed on State and local governments by H.R. 3838 are not readily discernible. The bill attempts to disguise the real and detrimental impact it will have on projects financed through the issuance of tax-exempt bonds by describing them as either nonessential or essential function bonds. I cannot comprehend how a group of Representatives and staffers in Washington can make such neat delineations and distinctions about which functions are essential or which are nonessential.

In effect, the House of Representatives has decided that States and cities may sell all of the tax-exempt bonds they want for sewers but not for solid-waste disposal plants; for schools but not for student loans; for streets but not for subways. Moreover, H.R. 3838 requires that, however admirable the purpose of the bond issue, the issuer had better spend 5 percent of the funds within 30 days or else the bonds will be declared taxable. If taxpayers fail to perceive the logic behind these provisions, they should not be surprised, because there is none. I again fail to comprehend how this bill can be considered tax reform.

I am also greatly troubled by the imposition of a unified annual State volume cap equal to the greater of $175 a person or $200 million. This cap is arbitrary and fails to recognize the importance of tax-exempts in providing essential services to many Americans. The caps on certain bonds ignores the economic realities of the costs of financing docks, airports, mass-commuting facilities, facilities for the furnishing of water, sewage disposal plants, solid waste disposal plants, and qualified residential rental projects.

The application of the volume cap to institutions such as the New York Hospital present a vivid example of the inequities created by the bill. The New York Hospital, a nonprofit hospital, had planned to undertake a $395 million renovation to upgrade the health care services it provides to thousands of New Yorkers. Under H.R. 3838, the cost of financing New York Hospital's improvements alone would use up a substantial portion of the State's allowance under the volume cap. The volume cap severely limits the access of vital institutions that provide vital public services such as nonprofit hospitals to the tax-exempt bond market.

The tax bill ends tax incentives during a time in which many Federal programs are being slated for termination. The Tax Reform Act of 1985 would have an adverse impact on homeowners, renters, and builders. Single family and multifamily housing development would be greatly hampered, if not eliminated, by many of the provisions in this bill.

The Tax Reform Act limits total housing bonds to $75 per person per year. In New York State this volume cap on both single and multifamily housing would limit the annual issuance of bonds to approximately $1.35 billion—$75×18 million population. This would decrease housing development in New York. H.R. 3838 provides that unless otherwise decided by the Governor, or State legislature, the total is divided into three parts: one-third for single family, one-third for multifamily, and one-third at the Governor's discretion. Assuming that the Governor or legislature divides the discretionary amount equally between single and multifamily bonds, the statewide allocation would be one-half single family and one-half multifamily or $675 million each.

However, in 1985, the New York City Housing Development Corporation [HDC], the New York State HFA, and SONYMA issued $1,616,000,000 in bonds for single and multifamily housing. Therefore, if this bill was in effect last year, New York would have exceeded its cap by over $250 million. Since it is expected that SONYMA would keep its entire allocation of $600 million from last year or slightly increase it to $675 million, all of the $250 million, one-quarter billion dollars, reduction would affect New York's multifamily housing.

SONYMA would also be affected by this volume cap. For example, under current law SONYMA can issue bonds in the amount of 9 percent of the average volume of mortgage originations for the preceding 3 years. In the computation for 1986, 1985's mortgages which were very high would replace the low of 1982. Therefore, SONYMA's limit would probably increase by $150 to $200 million under current law. Thus, even a small increase is actually a large decrease over what would have been possible in 1986 for SONYMA. Furthermore, the Tax Reform Act of 1985 would put SONYMA out of business in 1988.

This bill would not only reduce housing activity, but possibly halt or delay the continuation of major projects being developed in New York State, for example, New York's Battery Park City and Port Authority housing initiatives. The Tax Reform Act of 1985 would restrict the issuance of $400 million in bonds to finance low-income rental housing backed by surplus revenues from Battery Park City.

The Tax Reform Act's elimination of the 90/10 rule adversely impacts New York. It eliminates incentives for investment in rental housing and potentially increases cost for renters and homeowners. Presently, this provision allows 90 percent of the bond proceeds to be used for residential, and construction cost. The other 10 percent is for commercial use. However, this bill requires that all bond proceeds be used for residential development. Thus, States that mostly build garden apartments would not be adversely affected, but this provision would hurt States like New York that often develop residential and commercial or mixed used properties.

For example, almost all of the New York City Housing and Development Corporation's [HDC] 80/20's have ground floor commercial space. The use of commercial space ventures enhance project feasibility because stores often pay higher rents than ground floor residential units. Therefore, developers can offer lower rents to residential tenants in other parts of the building. The Tax Reform Act requires developers to finance commercial space with either equity or debt raised from a source other than the bond issue. But, using debt raised from sources other than the bond issue would prove problematic; it would involve complex legal and accounting work that would add to the total project cost. In addition, the cost of conventional debt would be higher and returns to the developer would decrease. Thus, it would be almost impossible to pass on lower rent benefits to residential tenants.

The House passed a nonbinding resolution calling for the delay of most effective dates until 1987, however the Tax Reform Act of 1985 makes its provisions effective retroactively on January 1, 1986. Grandfathering relief for projects underway as of September 25, 1986, is included in the House bill. In addition, the Senate passed a similar nonbinding resolution until 1987. However, there is no certainty as to the degree to which the effective dates in the Tax Reform Act or in the nonbinding resolutions would actually apply. Thus, there needs to be a clear message sent to the public as to the effective dates of the Tax Reform Act. Continued ambiguity on effective dates will cause market disruption and an adverse impact on projects slated for 1986. The people have a right to know whether tax reform is going to affect them retroactively. Why should they have to wait until a development project is completed to find out whether they will receive a tax incentive? They should know in advance. At a minimum, effective dates for any final tax reform legislation should be no earlier than January 1, 1987. Grandfathering rules should be underway prior to the end of 1986. This would give our citizenry an opportunity to move forward on the basis of current law incentives, and time to plan for the future.

I am also concerned about the effects this bill would have on several other tax incentives. H.R. 3838 restricts the utility of homeowner bond (builder bond) financing and treats loans for installment obligations as security payments on pledged obligations. It lengthens the depreciable life for most residential buildings from 19 to 30 years. In addition, there are very restrictive low-income housing provisions in H.R. 3838. For example, the Tax Reform Act of 1985 provides special incentives for investment in very low-income housing. This means that at least 40 percent of the units would be set aside for families earning 60 percent or less of the area median income. This poses a major problem because there is no available subsidy program that could produce rents low enough that would also be affordable by tenants at this level. Thus, low-income housing development could become a thing of the past.

Mr. Chairman, I am deeply concerned about the implications of the Tax Reform Act of 1985. Over the past 50 years, the Federal Government has played a major role in advancing national housing policies in its partnership with the housing industry. We have provided Federal tax incentives to promote homeownership and the availability of affordable housing. The Congress should not hastily concur with a bill that would drastically diminish housing in our great Nation.

The Federal Government should continue its commitment to providing incentives for the further development of our communities. This has been the key to affordable housing for families throughout the United States.

I hope that during our examination of H.R. 3838, we can reveal some of the major flaws in this legislation. Our efforts should not be undertaken with a desire to criticize our colleagues in the House, but to ensure that we accomplish the goals of tax reform—simplicity, fairness, and economic growth.

The **Chairman**. Senator Hecht.

Senator **Hecht**. Thank you, Mr. Chairman.

Senator D'Amato, I just heard on the morning news that the SBA is going to be wiped out so you might as well stay here where the action is.

Senator D'AMATO. I don't mind the SBA being wiped out, but what I really can't handle is the small businesses that may be because you will find in that 1,400 pages that it's chock-full of real surprises for the small businessman and not too many of them are good.

Senator HECHT. Mr. Chairman, I just want to make one point. Your background as a mayor has been invaluable to this committee and I think you understand these obligation bonds and tax exempts for the cities, the counties, and the States and this week we've been debating TV in the Senate and I continue to say that the Senate should not be a group of courtroom attorneys, so I think that your expertise in this field serves us well as a definite reason for voting against TV in the Senate.

I have no further statement.

Mr. GUTHMAN. Senator D'Amato, let me thank you for your statements and I hope that you will accept our invitation to join the National League of Cities when we have our congressional meeting next month and participate in our program.

Senator D'AMATO. You mean you like my nice quiet style?

Mr. GUTHMAN. Yes.

Senator D'AMATO. Thank you. If we can, we look forward to doing it.

The CHAIRMAN. Thank you very much. We appreciate your testimony.

Now if I could call the second panel, we are pleased to have you with us today. I am especially proud to have Mr. Edward Alter, a good close personal friend of mine, the treasurer of the State of Utah, to testify; Mr. David Herlinger, executive director, Colorado Housing Finance Authority; Mr. Leo Henikoff, Jr., president, Rush Presbyterian St. Luke's Medical Center and president of Rush University of Chicago, IL; William A. Holby, partner, King and Spaulding, Atlanta, GA, on behalf of the National Association of Bond Lawyers; Richard Kezer, senior vice president, Citibank of New York, on behalf of the Public Securities Association and Dealer Bank Association; and Bernard Tetreault, immediate past president, Association of Local Housing Finance Agencies.

Gentlemen, Mayor Suarez, mayor of Miami, was supposed to testify on the first panel but has been delayed because of the President's prayer breakfast, so we will go ahead and start with you and if you don't mind when he arrives we will interrupt you to hear his testimony so we can sort of get back in order.

Ed, would you like to proceed, please.

STATEMENT OF EDWARD ALTER, DIRECTOR TREASURER, STATE OF UTAH

Mr. ALTER. Thank you, Mr. Chairman, and good morning.

First, let me thank Senator D'Amato for giving my talk for me and I'll try and supplement his comments as best I can.

I am Ed Alter, the elected treasurer of the State of Utah and I'm here representing my State and also the National Association of

State Treasurers, who are the treasurers of the 50 States which group I represent as their first vice president.

NO INPUT BY LOCAL OR STATE SECTOR

I want to first give my sincere thanks to you, Senator Garn, and to this committee, for giving us the opportunity to appear here. I've been absolutely astounded by the fact that the public sector, the issuers whom I represent, those that I think are most affected by the bond provisions of H.R. 3838, have had little or no opportunity for input into the House process and so far even the Senate Finance Committee hearings.

Many municipal officials paid insufficient attention last fall to this onerous bill as it worked its way through the House and through the Ways and Means Committee simply because they could not believe that Congress could or would deal such a devastating blow to municipal finance, that is, to tax-exempt bonds for municipal purposes. But indeed, H.R. 3838 has dealt such a devastating blow.

My first concern is the harm done to the concept of federalism. Both the States and the Federal Government have long practiced the doctrine of reciprocal immunity with regard to tax-exemption of State-issued and of federally issued securities. We practice reciprocal immunity for the same reason that we try to avoid trade barriers with international trading partners. Trade barriers can only lead to trade wars and economic chaos and, similarly, Utah does not yet tax the interest earned on Treasury securities because we municipal issuers believe that we don't want our securities taxed by the Federal Government either. Obviously, one action will bring the other.

As was pointed out by Justice Marshall in *McCullough* v. *Maryland*, the power to tax is indeed the power to destroy. We don't want to invoke that power on either side.

Not only does H.R. 3838 take away from many traditional purchasers the expected tax exemption on our municipal bonds, but it imposes a direct tax on our securities by requiring a rebate of certain earnings from the proceeds of our bond issues. H.R. 3838 literally now requires the State of Utah to file a regular tax return and to remit a check to the Federal Government if we invest the bond proceeds in excess of the interest rate during the construction period on GO capital facility bonds. That's just totally an unacceptable destruction of this reciprocal immunity doctrine which we cherish so much from the Constitution.

Keep in mind now that this bill is not an attempt to curb abuses. Most of them have long since been eliminated by TEFRA and other prior legislation. Proponents of this legislation don't even claim to be addressing abuses.

They are simply making bold and aggressive new inroads into the tax exemption of State and municipal entities in order to gain another $3.1 billion of additional tax revenue over the next 5 years.

We have in this bill the Federal Government sitting in Washington declaring for Utah and its communities, and for other States and their communities, which purposes are governmental and non-governmental and which are essential and nonessential, and, for heaven's sake, which ones are taxable and tax exempt.

Right this very minute the citizens of Utah's fourth largest city are boiling their drinking water because of water contamination problems. Mayor Jenkins has half the city employees of the city of Provo working frantically to fix a problem in the water lines and to flush them out clean again. Do you think it would surprise him if we called him up this morning to say that clean drinking water is classified by H.R. 3838 as a nonessential purpose? If the citizens of that city were to flush their toilets and nothing goes down, do you think that they would agree with the Federal Government that sewer systems are nonessential and that bonds to finance them should be considered taxable if they don't fit under some arbitrary federally imposed cap?

That concept is simply outrageous. If under the concept of federalism we really believe that government is best when it's closest to the people, then we must allow municipal priorities to be determined at the local level, certainly not by H.R. 3838.

This bill totally denies tax exemption to certain traditional municipal projects such as federally mandated pollution control facilities, convention and sports facilities like the beautiful Salt Palace in downtown Salt Lake City, city parking facilities like the covered downtown parking garage in Ogden, UT, that has meant so much to downtown revitalization there, and general obligation urban renewal projects. Even general obligation and traditional revenue bonds for core government needs such as office buildings or the renovation of the city and county building in Salt Lake City are subject to tax if more than 10 percent of the proceeds are used in a private business. Now used is not defined, but presumably that means, for example, the leasing of space for a newstand concession or having a private contractor run the cafeteria, or renting space for dances or parties, all of which we do in the Utah State Capitol building itself. Ten percent or more of such use results in a taxable bond.

Bonds issued by Salt Lake City to finance its beautiful international airport, so vital to the growing economy of our State, would not at this point meet the 10-percent test and would hereafter be taxable. Again, I say that's absolutely outrageous.

DEATH KNELL OF PUBLIC-PRIVATE JOINT VENTURES

This bill is, unfortunately, also the death knell of privatization and public-private joint ventures which have enabled some municipalities to raise desperately needed capital in the private sector and to take some pressure off the municipal bond market.

A solid waste burn plant in North Davis County, UT, is an example of a mutually beneficial public-private partnership which is destroyed under this bill.

One of the most onerous provisions of H.R. 3838 is the statewide volume cap referred to earlier for so-called nonessential purpose bonds. Such a cap is particularly hard on small population, Western States with high growth characteristics. The cap includes bonds for drinking water facilities, for sewer facilities, solid waste disposal, single-family and multifamily housing, student loans, redevelopment or tax increment financing, mass commuting, and even some airport facilities.

The amount allowed is $175 per capita which gives Utah a total cap of about $250 million. We have recently averaged at least three times that amount of municipal financing for these kinds of needs in our State. How in the world are we going to squeeze 750 million dollars' worth of financing under a $250 million cap?

In the past few years we've averaged over $200 million of housing bonds per year alone, to provide single-family dwellings for our population. We have the highest internal growth rate of all the 50 States. How are we in Utah going to be able to provide water and sewer and other needed infrastructure for our future growth if some arbitrary Federal cap makes two-thirds of such financing 30 or 40 percent more expensive by becoming taxable?

Finally, let me mention that this bill mandates a myriad of detailed, complicated, and redundant rules and procedures, the violation of which can make any bond issue retroactively taxable to the date of issuance. This tremendous risk and uncertainty has already led to a two- or three-tiered market which some of my colleagues in the bond business can undoubtedly address better than I.

It is certain that this horrendous risk has already driven up the cost of tax-exempt financing proposals. Salt Lake County, for instance, estimates that its simple tax anticipation notes sold only last week cost at least $250,000 or 30 basis points more because of these new uncertainties.

Let me give a couple of examples of the new rules. H.R. 3838 imposes the 5-percent rule I referred to earlier which requires that 5 percent of the bond proceeds have to be spent within 30 days. Some States, including the great State of Georgia from whom we have already heard, have constitutional requirements that bond proceeds must be in hand before the contracts are let and it's obviously impossible for them to let those contracts and to pay for 5 percent of the work within 30 days. They probably couldn't live with a 60-day or a 90-day maximum either.

That's a perfect example of the arbitrary, capricious, completely insensitive, and the unreasonable nature of this Federal straitjacket legislation. Further, new arbitrage restrictions requiring the remittance to the Treasury of essentially 100 percent of the earned profits on investments are also examples of this additional redtape. The earning of interest on bond proceeds during the construction period is not an abuse of tax exemption. In Utah, as in most other States, such arbitrage earnings are invariably used to reduce the size of the expected bond issue. Loss of arbitrage will only force us all to larger financings for the same projects.

BILL ADDS TO ADMINISTRATIVE COSTS

Last, the detailed reporting remittance and accounting requirements mandated by H.R. 3838 will greatly add to the administrative burdens. We really can't estimate the real cost of it, but it will be significant and, remember, a simple administrative oversight, an honest accounting error, can cause the whole bond issue to become immediately and retroactively taxable.

Now all of this is heaped on us by the Federal Government at the very time it cuts the Federal revenue sharing to State and local governments. Just as this greater financial burden shifts to us, H.R. 3838 takes away the necessary tools to cope with it. It simply devastates us.

Please ponder that this madness is being perpetrated on the State and local governments who have always painfully balanced their budgets and acted in a fiscally responsible way, and have even run surpluses in some years by a Federal Government whose own financial house has been grossly out of order lo these many years.

Recently the Supreme Court has told the States in the *Garcia* case that our primary protection from an overzealous Federal Government and encroachment into the hallowed constitutional protections is our own political representation in the Federal process. We are counting on you to protect reciprocal immunity and our vital municipal bonding interests.

Thank you very much.

[The complete prepared statement follows:]

National Association of State Treasurers

HON. BILL COLE
President
404 Walter Sillers Building
P.O. Box 138
Jackson, MS 39205
(601) 359-3531

HON. EDWARD T. ALTER
Senior Vice President
215 State Capitol Building
Salt Lake City, UT 84114
(801) 533-5781

HON. CHARLES P. SMITH
Secretary-Treasurer
125 S. Webster Street
P.O. Box 7871
Madison, WI 53707-7871
(608) 266-3711

HON. R. BUDD DWYER
Eastern Region Vice President
129 Finance Building
Harrisburg, PA 17120
(717) 787-2465

HON. ANN W. RICHARDS
Southern Region Vice President
LBJ State Office Building
P.O. Box 12608, Capitol Station
Austin, TX 78711
(512) 463-6000

HON. MICHAEL L. FITZGERALD
Midwestern Region Vice President
State Capitol
Des Moines, IA 50319
(515) 281-5366

HON. BILL RUTHERFORD
Western Region Vice President
158 State Capitol
Salem, OR 97310
(503) 378-4329

HON. WENDELL BAILEY
Ex. Officio Host State Member
P.O. Box 210
Jefferson City, MO 65102
(314) 751-2411

HON. HENRY E. PARKER
Past President
20 Trinity Street
Hartford, CT 06106
(203) 566-5050

The so called "Tax Reform" bill passed by the House of Representatives includes a very damaging attack on the ability of state and local government to issue tax-exempt bonds for public purposes.

- The bill would do great harm to the principles of federalism by seriously eroding the constitutional standard of reciprocal tax-exemption between state and federal debt securities.

- The bill is not an attempt to simply curb perceived "abuses" in tax-exempt financing. Most if not all abuses were eliminated by the TEFRA and DEFRA legislation in 1982 and 1984. Ironically, small issue Industrial Development Bonds, long viewed as a source of problems, are given new life by the House Bill. This bill is a major new step in the two-decade long attempt to regulate and eliminate tax-exempt bonds carried out by the U.S. Treasury Department and the staff of the Joint Committee on Taxation.

- The bill seeks to establish the principle that the Federal Government, without any input from the states, can define which of the bonds issued by state and local government are for "essential" purposes and which are "nonessential". It may surprise you to know that Congress thinks "nonessentials" include: airports, hospitals, student loans, multifamily housing, sewage disposal facilities, solid waste disposal and resource recovery facilities, ports, mass commuting facilities and water supply systems.

- Based on these categories, the bill makes "tax-exempt" interest on "nonessential" purpose bonds subject to the tough new Federal "Alternative Minimum Tax", thus partially removing the exemption and significantly raising interest costs to the issuing government.

- The bill totally denies tax-exemption for other specific public benefit functions. They include: pollution control facilities; convention centers or sports facilities where any limited group of organizations has an extended right to use the facilities; parking facilities except at airports; airport hotels, restaurants, etc.; industrial parks; and local district heating and cooling facilities.

- Even General Obligation Bonds or Traditional Revenue Bonds can be "nonessential function" bonds, and be subject to the alternative minimum tax regardless of the credit or tax source supporting the financing issued in your state, if:

    - more than 10% or $10 million of the issue is "used" in private business such as through a facility management contract, or a "take-or-pay" sales contract.

    - more than 5% or $5 million is "loaned" to any private business.

These terms deal a death-blow to privitization efforts and most public-privat cooperative ventures.

SECRETARIAT The Council of State Governments, Marysia Tobin, P.O. Box 11910, Lexington, KY 40578
Telephone (606) 252-2291, and 444 N. Capitol Street, Washington, DC 20001 Telephone (202) 624-5460

- In addition, any portion over $1 million of any General Obligation Bond or Traditional Purpose Revenue Bond which is "used" by or "loaned" to other than a "natural person" must compete for an allocation of a new statewide volume cap, described below.

- The new statewide "volume cap" would place an absolute aggregate limit of $200 million or $175/capita on the so called "nonessential" purpose bonds:

    - $25/capita would be permanently reserved for charitable hospitals, non-public universities and other 501(c)(3) organizations.

    - $75/capita would be temporarily reserved for housing bonds, both single and multifamily.

    - $75/capita would be temporarily reserved for all other "nonessential" bonds, excluding airports and ports.

  These limits are significantly below current volume levels and will sharply curtail the financing of critically needed infrastructure and other programs at precisely the time that more responsibility is being shifted to state and local governments.

- The legislation severely limits the ability of issuers to refinance debt so as to achieve interest rate savings, remove restrictive covenants, or restructure debt.

- In addition, the bill sets forth a number of detailed, redundant, and, in many cases very harmful procedural rules, the violation of which can make any bond issue retroactively taxable to the date of issuance. The uncertainty caused by this potential risk will lead to much higher interest costs. Some examples of these rules are:

    - A requirement that the issuer spend 5% of net bond proceeds within 30 days of issuance. This is in direct conflict with many prudent state and local contracting laws which require that funds be in hand before contracts are bid.

    - The imposition of new detailed arbitrage restrictions which require remitting to the Treasury essentially 100% of earned profits on investments.

    - The bill prescribes "micro-management" of state and local fiscal affairs by the Treasury Department, mandated through detailed reporting, remittance and accounting requirements pertaining to bonds.

- This legislation is a clear attempt to establish the precedent that Federal rules will govern every aspect of the issuance of state and local securities.

The CHAIRMAN. Thank you, Ed. I not only appreciate your testimony, but so do the staff and others who know me well, because they are finding out that all of us from Utah are rather direct and blunt. It isn't just me that says what I think. You do, too, because I'm sure that there's nobody who misunderstood your testimony. I could put you with Senator D'Amato as probably against.

Mr. ALTER. Indeed. The overall impact of the tax provisions—that is, the bonding provisions of H.R. 3838 are nothing short of devastating to the States and the communities. That's the bottom line.

The CHAIRMAN. Mr. Herlinger.

STATEMENT OF DAVID HERLINGER, EXECUTIVE DIRECTOR, COLORADO HOUSING FINANCE AUTHORITY, ON BEHALF OF THE CIL COUNCIL, COUNCIL OF STATE HOUSING AGENCIES

Mr. HERLINGER. Mr. Chairman, good morning.

My name is David Herlinger. I'm the executive director of the Colorado Housing Finance Authority, a member of the board of directors, and a past president of the Council of State Housing Agencies, and I'm here today on behalf of the council which represents 49 State finance authorities or agencies, Puerto Rico, the District of Columbia, and the Virgin Islands.

I want to commend you as chairman of this committee for holding these hearings. I think that if each of the committees in the Senate would explore the ramifications of the proposed tax reform bill that are particularly related to H.R. 3838 in areas of their jurisdiction, I think a thorough analysis by the Senate would show just how outrageous portions of that tax reform bill are.

FOCUS ON HOUSING

What I want to try to do this morning is to focus obviously primarily on housing and set the scene for a later panel which will be pretty much exclusively devoted to the housing portion of tax reform issues.

You're going to hear from a variety of people over the remainder of the day. Let me deal with policy issues related to both issuers and consumers because I don't think that anybody at this point that I'm aware of has dealt really with any of the reality of the consumers of housing bonds.

We're the ones on the firing line in that area. Historically, the Federal Government has been in the business of providing housing for poor people for 50 years. Over the past few years, that relationship and that involvement has been decreasing and if the President's recent budget proposal is approved, the Federal Government will be, for the most part, out of the production of new housing for poor people or the rehabilitation of housing for poor people.

At the same time, the Federal Government is saying to the State and local governments that this arena, this area of housing for poor people, is your responsibility. It's the responsibility of State and local governments.

Who are we talking about? We're talking about people, elderly on fixed income, handicapped, developmentally disabled, homeless, low-income families, and modest income, first-time homebuyers, young couples. That's who we're talking about, the people who are falling through the cracks and who are not continuing to benefit from the deductibility on home mortgage payments which was left unchanged in the House version of the tax reform bill.

Now the only viable tool left, tax-exempt financing for housing, is under attack again. I believe personally that in the area of housing H.R. 3838 is a mean-hearted, noncaring, piecemeal effort and it's evidenced by housing bonds being called nonessential. The treasurer just mentioned several other uses. Well, housing is also a nonessential use according to the Ways and Means Committee in the House of Representatives.

If passed as outlined and approved by the House of Representatives, an enormous blow at State and local efforts which have been developing over the past few years would simply eliminate that effort of local and State governments trying to deal with the housing problems of people in their communities because housing does two things.

Housing production—that is, the production of housing for people, even poor people, has two significant immediate effects. One is it produces the housing. Another is that it produces jobs, economic development. Those two have always been linked and that's the reality of it and jobs are created when housing is built for poor people.

Another point I'd like to make. In 1973, the legislature in Colorado created the Colorado Housing Finance Authority. The intent then, as now, was that our direction on the part of State government was to provide a vehicle for housing production for poor people in cooperation with the private sector and we have done that over the past 12 or 13 years.

We have worked with well over 120 lending institutions around the State of all kinds, small savings and loans, large savings and loans, rural, urban, mortgage bankers, commercial banks. All of those people have participated with us for a variety of reasons, including the fact that they understand what public policy and public purpose is about. They also understand that conventional financing simply doesn't do it for a significant number of people. Our homeownership program over the years has averaged—the average income of a family purchasing a home has been $19,000. That is not outrageous. That is very, very modest income, and we do that by specifically targeting.

Over the past month or so we've been sitting down with lenders, and builders, and others in the private sector outlining various aspects of H.R. 3838 to them and getting their reaction and their reaction is that if this were to pass there is no way they would continue to participate with us in the production of housing for low-income people.

They've used words like "harassment," "unreasonable," "senseless," "unprofitable," and maybe unprofitable is a key one. It certainly is.

So we have proposed Federal legislation that sends the message to Colorado and the other States that the Federal Government has outlawed public-private cooperation and relationships built over the last 13 years that have housed in Colorado 100,000 people. It's just outrageous. It's just totally and absolutely outrageous.

You're going to be hearing a lot of specific problems and proposals later today and in the near future and we will be submitting to you—that is, the Council of State Housing Agencies—next week a complete proposal where we feel that both a reasonable and workable program for housing bonds can be developed. We submitted a similar proposal to the House and for the most part it was disregarded.

Let me go through some items very quickly. Volume: H.R. 3838 proposes a volume cap on housing and is lumped together with all other forms of nonessential bonds. We don't disagree with a volume cap for housing. However, we do think the cap should be set aside. It should be its own cap and should not be tied together with caps of other nonessential bonds. I don't really like that term—nonessential bonds. It's, again, apparently to the House of Representatives, housing for the poor people is nonessential. We feel that that authority ought to be able to be carried forward for 3 years in the event it is not used. What we have found, certainly in my own experience in Colorado, I can see that by having an annual authority that ends at the end of the calendar year, a lot of unsophisticated local issuers get themselves into real problems by rushing to the markets because the attitude is we've got to use it or lose it, and that's just absolutely silly and lots of bad deals have been made by some very unsophisticated issuers around the country and a carryforward provision would eliminate that.

ELIMINATE SUNSET ON MORTGAGE REVENUE BONDS ON HOME OWNERSHIP

The second item. There presently is a sunset on mortgage revenue bonds for homeownership. That is December 31, 1987. That is, the MRB program sunsets the end of next year. It's only nonessential bonds that now has a sunset. We believe that that needs to be eliminated because that issue is not going to go away. The small issue IDB sunset provision was eliminated in the House and we feel that the mortgage revenue bond sunset should be eliminated in the Senate.

We agree with the notion of lower income people should have the first opportunity for loans. We think that that ought to be codified in the Senate. It ought to be required. But what ought to happen is that the State or local government should be the one to implement that and there are a number of ways to do that.

We have implemented a program like that prior to any Federal legislation even being enacted dealing with that and, in large part, that's why we've been able to have an average income of $19,000 on the people that have purchased our homes.

If you determine that income limits are required, it seems to me that rather than impose them from the Federal Government, what you simply ought to do is require that the State legislature deal with those within the context of the bill—low- or moderate-income people, lower income people first and so forth. So federally imposed income limits just are not reasonable given the fact that this is an enormous country. New York City is a lot different than Denver, CO, is a lot different than Alamosa, CO, and that's just the reality of it and if you feel that income limits are necessary, make the

State legislature, the State government, deal with that issue, most of which have done that anyway.

We agree that a sales price limit is not unreasonable. That is covered in H.R. 3838.

Rental housing is in jeopardy because of the elimination and reduction of depreciation benefits to developers. That portion of the Tax Code should remain as is. This is an issue, again back to the public-private sector cooperation. You can't say to the private sector guys, "Come and help us provide this product to low-income consumers" and not provide any sort of incentive to them. That's just outrageous. The real world does not work like that and you know that and I know that.

It's another signal as outlined in H.R. 3838 to the private sector that they can forget about housing for poor people.

We are also concerned about the existing rental portfolio that we have in all of our investments and the possibility that changes in the Tax Code would—you would have owners of property not be able to sell that property after their existing benefits have declined and that concerns us greatly and we think that there could be some significant loss of rental property for low- and moderate-income people over that particular issue.

An issue that needs to be addressed—and this is particularly a city issue on rental housing—is that under the House version there is no commercial use allowed in any rental development that is built or renovated, and that's absolutely crucial. The present law allows 10 percent of the space to be used for commercial space. Personally, I think that should be increased to 20 percent because what happens is that that commercial revenue helps to subsidize the rents of the low-income people and to simply say that you can't mix any commercial use into an apartment house for the elderly is just outrageous. It's silly. It makes absolutely no sense at all. It's harassment and it's, again, another clear signal to forget low-income people.

There have been several who mentioned this morning the 5-percent problem. That's an easy one to pick on for homeownership because you can't even get a conventional loan closed in 30 days, much less one of the Mortgage Revenue Bond Program loans because of all of the qualifications, all of the hoops that people have to run through. Good grief, right now, our buyers have to sign an 11-page affidavit that virtually gives away everything, that they're pure and will always remain so, and how that's going to be accomplished within 30 days, closing one of those loans, after the bonds are sold and at the same time deal with the issue of lower income people first—the only way to do it is to cheat. That's the only way as an issuer. We haven't worked through the aspects of that, but clearly the way to get around that is to cheat if that were to become the law.

The retroactive date is a problem in Colorado not just for housing but for really all issuers. What we've got right now is pretty much chaos with the general assembly saying, "We aren't going to pass any sort of law because there's nothing really to work off of." The Governor saying, "I'll do an executive order but I'm not quite sure what it should say." The attorney general saying, "I don't know what it should say either." Various bond counsels for a number of issuers are proposing different kinds of executive orders and as a result nothing is happening and probably nothing will happen in that arena because of this 1985 yearend date.

CONCERN FOR CONSUMERS

So I guess to summarize this and complete my statement, I think there needs to be more concern about the consumers. Let's take a look at the consumers. The first-time homebuyers, the low-income families, the elderly on fixed incomes, handicapped, homeless—right now, the major efforts to house those people are at the State and local levels and what has been proposed and what the result of H.R. 3838 if adopted by the Senate would be that those people would lose the opportunity to have any sort of decent housing at all.

I guess in closing what I'd simply ask you to do that you look at it in an open manner and recognize that those people count also and that there are some reasonable ways to attack the problem of housing bonds and housing people.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Cranston, do you have anything you would like to say before we move to the next witness?

STATEMENT OF SENATOR CRANSTON

Senator CRANSTON. I'd like to just very briefly welcome the witnesses to these very important hearings and I thank you, Mr. Chairman, for holding them.

I am very concerned that under the tax and budget proposals of this administration there will be no safety net for housing for low- and moderate-income people.

The President's budget and tax proposals are absolutely insensitive in that regard. Many of the changes being proposed have no revenue impact and therefore are, I think, mean and cruel, and I'm giving my commitment today to make every effort to change this approach.

The proposals being put forth not only will destroy future prospects for housing but also endanger 20 years of existing housing stock that has been built with Federal incentives.

We must ensure that the safety net for housing, for those people who have the greatest need remains in place. America, presently is the best-housed Nation in the world, despite the fact that many Americans are not decently housed at present. That has come about in part because of ingenuity of the free enterprise system and the capacity of those who prosper under it to pay for their own housing, but it's also come about by programs that the Government has put together to promote housing.

We've had a combination of programs that require expenditures by the Federal Government one way or another and programs that depend upon tax incentives.

If we are to abandon the tax incentive side at a time when it's obviously impossible to maintain budget expenditure type programs, then we're going to see a collapse of the opportunity for many Americans to have decent housing that do not have it now.

So I don't think we can scrap what we have in the Tax Code for that purpose at a time when on the budget side virtually all of the spending type programs have been obliterated. If we now obliterate the tax incentive type programs we would be absolutely nowhere and I'm going to do whatever I can to see that that is not the course we follow.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Senator. Your statement has been very mild compared to what the witnesses have said about the bill proposed.

[Senator Cranston's complete statement follows:]

STATEMENT OF SENATOR ALAN CRANSTON

Today's hearings on the impact of tax reform on housing, real estate, and tax exempt bonds and securities cover this committee's critically important responsibilities for housing and urban affairs.

I do not see these hearings as questioning the merits or lack of merit of tax reform. I see them rather as an examination of the impact of specific tax reform proposals on programs and subjects of committee concern.

The Tax Reform bill, as passed by the House, and the tax reform as well as the budget proposals of the President, impact very heavily upon the housing policy of the Nation, a policy that has been designated to encourage widespread home ownership and the provision of affordable, decent housing for all Americans. These budget proposals also strike at the role of State and local governments to plan and encourage local economic development. The House bill does this by depriving local redevelopment agencies of essential tax-exempt financing tools necessary for planned development.

Last year I held over 50 community forums in California on a variety of subjects, but principally on tax reform. I learned that many Californians are interested in tax reform but are skeptical about the details of any plan. Californians, like taxpayers everywhere resent the fact that under current law some taxpayers pay more than others with the same income, some pay much less and some pay no taxes at all. Many people told me that resentment over the perceived unfairness in the Tax Code has undermined their respect and support for the law.

The Internal Revenue Service estimates that noncompliance with the Tax Code costs nearly $80 to $100 billion in uncollected revenues. That is an enormous amount of revenue and in measuring the benefit of tax reform we should take into account the gains which will accrue as a result of increased respect for fairness of the tax system.

If that were all there were to the argument, adoption of some version of tax reform would be inevitable. But we don't use our tax system just for revenues. We use it for other social or economic purposes. We use it to help industry through liberalized capital recovery provisions. We use it to encourage investments and savings which might otherwise not be made. And we use it to help local and State governments sell bonds by exempting interest from Federal taxation.

At each of the community forums I held in California on tax reform I began the discussion by asking people these two fundamental questions which I believe, Mr. Chairman, will help the members of this committee shape their views on the questions raised by tax reform.

1. Is the tax system the best way to subsidize—in an effort to stimulate—the American economy? We could after all, provide the same help through direct expenditures, subsidy payments, loan guarantees and other means which do not involve the Tax Code. But these would involve direct outlays from the Treasury. And it's hardly likely that any new spending will be approved at a time when there's a major effort underway to cut spending. Even though substituting a limited spending subsidy could be cheaper than a tax subsidy which can't be limited.

Would such alternatives be good ideas? More to the point, are they—right now at least—politically practical?

2. Do the benefits our economy and our society derive from the current tax system outweigh the fact that it places an unfair tax burden on the majority of Americans?

In the long run, is it worth it to three out of four American taxpayers to pay more taxes than they would under a modified flat tax plan, so that the economy or particular industries can be helped by permitting wealthy investors to pay proportionately lower taxes?

And if we decide to adopt a tax reform proposal, what are the few deductions we should retain?

These are not easy questions.

These hearings are the first consideration the Banking, Housing and Urban Affairs Committee has given to these critical and difficult questions.

Housing and real estate benefit from a number of tax provisions designed to encourage home ownership, the provision of an adequate supply of rental housing, including housing affordable to low-income families, and the rehabilitation and renovation of older buildings and communities.

These provisions work and work well. These tax provisions together with Federal mortgage insurance programs and other mortgage finance efforts sponsored by the Federal Government have succeeded in making ours the best housed Nation in the world—all on the basis of free choice and a free market.

I would like to observe here, Mr. Chairman, that the American housing industry is uniquely American. There is no other in the world so efficient and successful. And, so far, houses are not being imported into the United States—no trade deficit there, yet. But if we increase the cost of capital to housing, there could well be.

Home ownership generally fares well under the House tax reform bill. The deduction for home mortgage interest is preserved, the tax-free treatment of capital gains on the sale and new purchase of a home is retained, as well as the exclusion of $150,000 of gains on the sale of one's principal residence after age 55. The house tax bill also retains the full deduction for payment of local real estate taxes as well as sales and income taxes.

Rental housing, however, does not fare as well. Depreciation periods are lengthened. Rehabilitation credits are limited or denied. Tax-exempt bonds for mortgage subsidies are strictly capped. And—the tax subsidy program for rehabilitation and provision of multifamily housing for low-income families is wiped out.

Mr. Chairman, at this point I would remind my colleagues of the two policy questions I posed earlier. And I would like to restate them as they apply to the tax subsidy program for low-income housing.

Should we provide for low-income family housing through the Tax Code or should we enact a new subsidized housing program for the hundreds of thousands of urban and rural families who need affordable, decent housing?

It is time this committee recognized that we have allowed the administration and Congress to repeal virtually all federal programs to house low-income families. The sole program for the provision of low-income family housing today consists of the HUD Rehabilitation Program which is subsidized directly through the Federal income tax.

Many Senators have attacked the tax subsidy because they perceive the program as sheltering excessive amounts of income from Federal taxation in ways which to them are objectionable. In this criticism of the program they are joined by the Treasury Department's tax reformers who say the need for subsidized low-income housing must be met through Federal spending programs. And indeed the administration this year proposes a Housing Voucher Program which will serve 50,000 families equally divided between rural and urban areas nationwide. I urge the committee to study and compare carefully these two methods of providing housing for low-income families and not prejudge the matter.

The house tax reform bill follows the lead of the President in limiting the issuance of tax-exempt securities by municipalities and State governments.

The limitations as contained in the House bill destroy the primary redevelopment financing tool used in my State as well as 38 others, including, Mr. Chairman the State of Utah. These redevelopment bonds are limited by the House bill under an analysis which finds they carry out "nonessential government functions"—even though they are funded by tax revenues pursuant to a vote establishing a redevelopment area in blighted or economically disadvantaged areas of communities.

I question the wisdom of the taxwriters of Congress who have assumed upon themselves the wisdom to tell State and local governments under our Federal system what is and is not an "essential government function." A brief review of the House committee report suggests that this concept lacks intellectual coherence and is little more than a cover for arbitrarily deciding whose ox is going to be gored.

The essential question about the function of government is one I can resolve quickly. In my view, it is a proper function of government to decide to plan for and to assist financially the redevelopment of blighted areas just as it is a proper function of government to decide to build new water and sewer lines into outlying areas of undeveloped land in order to encourage building.

Congress does have a role in helping to referee the Federal system. Through the tax laws we can provide standards that apply to all jurisdictions equally and we can prevent abuses. But in doing so we ought to follow principles which rise above subjective judgments as to what constitutes a proper end use of tax exempt financing. One such principle, I suggest, is to accept as an essential government function, a decision of a political subdivision, subject to local checks and balances, to commit local tax revenues for redevelopment without dictating what kinds of businesses may or may not be located within a redevelopment area. Afterall, that is up to the determination of locally elected officials.

I do appreciate the opportunity our committee will have to consider testimony on the impact of tax reform on our areas of jurisdiction and I hope that we will have an opportunity to discuss our conclusions and recommendations, if any, before the Finance Committee starts to mark up a tax reform bill.

Thank you.

The **Chairman**. Mr. Henikoff.

STATEMENT OF LEO HENIKOFF, JR., PRESIDENT, RUSH PRESBYTERIAN ST. LUKE'S MEDICAL CENTER, AND PRESIDENT, RUSH UNIVERSITY, CHICAGO, IL

Mr. **Henikoff**. Mr. Chairman and Senator Cranston, my name is Leo Henikoff. I'm a physician and president of Rush Presbyterian St. Luke's Medical Center and Rush University in Chicago. I am still actively seeing patients who are children with heart disease.

The **Chairman**. Do you have any recommendations for this voice, doctor?

Mr. **Henikoff**. No recommendations, sir. I appreciate the opportunity to discuss something different from heart disease, the tax-exempt financing issues that are related to the Tax Reform Act of 1985, and I'm grateful to you and this committee for its recognition of the issues through this hearing.

[The complete prepared statement follows:]

STATEMENT OF

LEO M. HENIKOFF, M.D.
President
Rush-Presbyterian-St. Luke's Medical Center

Before The
Committee on Banking, Housing and Urban Affairs
United States Senate
Hearings on Issues Relating to the
Tax Reform Act of 1985 (H.R. 3839)

February 6, 1986

STATEMENT OF RUSH-PRESBYTERIAN-ST. LUKE'S MEDICAL CENTER ON TAX-EXEMPT FINANCING ISSUES RELATED TO THE TAX REFORM ACT OF 1985

Mr. Chairman and members of the Committee, my name is Leo M. Henikoff and I am a physician and president of Rush-Presbyterian-St. Luke's Medical Center and Rush University in Chicago. I appreciate this opportunity to discuss the tax-exempt financing issues related to the Tax Reform Act of 1985 and am grateful to the Committee for its recognition of the issues through this hearing.

Rush-Presbyterian-St. Luke's Medical Center is a health delivery system in Chicago, Illinois, designed to serve 1.5 million people through its 1,265 licensed hospital beds, its HMO with 125,000 enrollees, and affiliations with 17 community hospitals and health care institutions. Its academic arm, Rush University, consists of colleges of medicine, nursing, allied health, and a graduate college and has affiliations with 16 liberal arts colleges and universities. This system represents an organization of more than 9,000 people working at the medical center, including medical and scientific staff, faculty, students, and employees.

Academic medical centers, such as ours, measure ourselves in terms of quality of care, excellence in education, productivity in research, participation in community service as well as in terms of financial strength -- or at least fiscal viability. With major reductions in both Medicare and Medicaid reimbursement (which is detailed in my written testimony) and with healthy competition engendered by private sector payors, there is no longer the opportunity to support indigent care by charging another payor for this cost. I would note that in response to these varied pressures our institution has had no increase of prices for the basic daily hospital services or for any ancillary hospital inpatient services since July 1983, and none is anticipated through June 1986.

The ability of institutions such as ours to fulfill our public missions is being stressed in the current environment. The tax-exempt financing provisions of the proposed Tax Reform Act of 1985 are particularly threatening in this regard and are the problem that I wish to address today. In discussing the problem of access to capital for our not-for-profit health care institutions I will not be addressing the severe negative impact on charitable giving that would derive from passage of the Tax Reform Act of 1985. I will only mention that it is another pressure, and a serious one, that makes continued access to tax-exempt financing all the more important for our institutions.

The most serious negative aspect of H.R. 3838 is the severe limitation on access to tax-exempt debt financing for health care and educational institutions. The limitation of tax-exempt debt for hospital purposes at $25 per capita per state, if in place in Illinois in 1984 and 1985, would have limited the volume of such offerings to 67% of the actual experience in 1984 and only 13% of the actual experience in 1985. It is questionable how successful hospitals would have been in competition within the $75 per capita pool that must fund a myriad of other activities which are perhaps more directly related to the functioning of the state and its municipalities. I wish to stress that health care institutions today are not borrowing to build new beds. Borrowings today are primarily for the replacement of assets and existing hospital beds which need to be replaced, often to meet life safety codes. The $25 per capita limitation would essentially deny access to the market for a significant number of institutions.

Elimination of advance refunding opportunities as proposed in the bill would have two major drawbacks:

First, because hospital issues usually are not callable for at least 5 to 10 years it would remove the opportunity to stay current in a period of falling interest rates. Removal of this opportunity would simply add to the capital costs of our institutions, with some of that cost being passed on to the federal government as long as capital costs are a pass-through in the prospective pricing system. Secondly, elmination of advance refunding would also severely impair the ability of institutions to eliminate covenants that become outdated or unworkable. Covenants in existing bond issues often mitigate against hospital merger, and the advance refunding mechanism is an important enabling measure in this regard.

Several provisions of H.R. 3838 further restrict assets that may be financed through tax-exempt debt or restrict the amount of financing that may be obtained for a particular asset. The provision that restricts financing to 120% of the asset's economic life will serve merely to increase the amount of principal for tax-exempt borrowing and further aggravates the competition within the volume limitation elsewhere in the bill. Restrictions on the type of asset eligible for financing in our case would have eliminated financing of a professional office building used by our faculty and staff to give a large volume of outpatient care to recipients of public funding in the Medicare and Medicaid programs. I do not believe that this is the intent of the law.

Several provisions of H.R. 3838 limit the benefits from tax-exempt debt. These include the application of an alternative minimum tax to tax-exempt debt issued after January 1, 1986. It is predicted that this provision alone could add 150 basis points to the cost of servicing this tax-exempt debt, should the debt itself be available. Restriction of arbitrage earnings over and above current restrictions will serve merely to increase the cost of capital for a large portion of the health care industry which is currently under tight cost constraints.

It is hoped that in your deliberations you will consider the simultaneous effects of capital costs being made part of the DRG payment and the fallout of H.R. 3838. In effect this is a "double whammy". Inclusion of capital costs within the DRG rate will, in and of itself, decrease the bond ratings of our health care institutions. At the same time limiting access to the tax-exempt market and making tax-exempt financing more costly (as with the alternative minimum tax provision) will act further to reduce our bond ratings. There is serious concern that the industry may resort to short-term financing of long-term assets, which certainly is attractive when rates are low, but is not a sound policy to ensure the stability of an essential service industry.

To summarize the current situation, the legislation passed by the House in 1985 would result in higher capital costs and an inequitable distribution of tax-exempt financing for health care and higher education institutions. We believe the best solution to the issues raised by the Tax Reform Act of 1985 is an elimination of any inappropriate uses of tax-exempt debt and would work with the Senate and the Administration to accomplish this goal. However, health care and higher education need the continued ability to finance capital assets on a tax-exempt basis without the volume restrictions in this bill.

Our public service mission has historically been interpreted as being vital to the well-being of our citizenry. The discrimination between private, not-for-profit hospitals and public hospitals engendered by H.R. 3838 is a break from the historical interpretation of our role in society. In the city of Chicago, where a major public hospital does exist, the private, not-for-profit hospitals supply over 85% of the indigent in-hospital care. There are many other communities in which no public hospital exists. This change in perception of the role of the voluntary sector could well be an interpretation that is translated into reality by legislation such as this. This is not the will of the people nor is it the desire of our institutions.

I appreciate this opportunity to testify before you and will be pleased to address any questions that you may have.

The CHAIRMAN. Thank you.
Mr. Holby.

STATEMENT OF WILLIAM A. HOLBY, ATTORNEY, KING & SPALDING, ATLANTA, GA, ON BEHALF OF THE NATIONAL ASSOCIATION OF BOND LAWYERS

Mr. HOLBY. My name is Bill Holby and I am a bond attorney with the firm of King & Spalding in Atlanta, GA. I am here today representing the National Association of Bond Lawyers.

I am going to make some points today regarding the impact of H.R. 3838 on the municipal bond market. I might preface my remarks, however, by saying that I cannot illustrate my comments as vividly as Ed Alter, as he described the boiling of water for purity and the inability to flush toilets. I will try to move as quickly as I can through what may be a slightly more dry subject.

The thrust of my testimony today will underscore testimony you have heard earlier from Mr. Guthman to the effect that the House bill will prevent financial institutions such as banks and insurance companies from doing the job they ought to do for our State and local governments. In attempting to increase the tax liability of banks and insurance companies, the bill undermines the efficiency of the tax-exempt market by effectively taxing municipal bonds.

DISALLOWANCE OF INTEREST EXPENSE ON TAX-EXEMPT BONDS

One device implemented is the disallowance of the deduction by banks of all interest expense allocable to the purchase of tax-exempt bonds. Historically, banks have been permitted to deduct all interest expenses, even though they may have invested in tax-exempt bonds. Tax legislation in 1982 and in 1984, however, reduced by 20 percent the deduction of interest relating to tax preference items, including interest allocated to the cost of purchasing tax-exempt obligations. The bill now provides that no deduction shall be allowed for this interest, with limited exceptions.

These deduction disallowance provisions ignore the role of banks in State and local government finance. Banks, which presently are second only to individuals as purchasers of municipal bonds, will not invest in these obligations when the yield is not competitive with taxable investments. But by eliminating the demand of financial institutions for tax-exempt bonds, interest rates will be driven up. Individual investors may fill the void, but not without an increase in the required yield.

The most hard hit by the elimination of banks from the market will be those least able to bear the burden. While all State and local government issuers depend on banks to acquire their obligations, small- and middle-sized municipalities will find it difficult to find any market for their bonds.

It has been suggested that existing laws provide a competitive advantage in this respect for banks. This simply is not the case. Any such disadvantage may be avoided, for example, through underwriting syndication practices or through the negotiated presale of bonds. Perhaps more importantly, the tax position of dealers is essentially the same as for banks, because dealers may allocate their interest expense in such a way that the interest is not associated with the purchase of tax-exempt obligations, and, therefore, is deductible. As a result, the impact of the bill may be to impose upon banks the very competitive disadvantage that is intended to be removed.

The bill adds another tax on municipal interest by restricting the ability of property and casualty insurance companies to deduct reserves for losses. The bill provides that, through 1987, this deduction must be reduced by 10 percent of the tax-exempt interest earned by these companies on bonds purchased after November 15, 1985. Beginning in 1988, this deduction is increased to 15 percent. This provision effectively imposes a 3.6-percent tax on presumably tax-exempt income prior to 1988, and a 5.4-percent tax thereafter. The involvement of these insurance companies in the municipal market is further complicated by the application to them of a special alternative minimum tax. For firms subject to this tax, income on municipal obligations purchased after November 15, 1985, will be taxed at the same 20-percent rate as income from all other sources.

Just as the interest deduction disallowance will eliminate banks from the short- and intermediate-term market, these provisions affecting insurance companies will remove them from the intermediate- and long-term markets. Again, yields on the bonds undoubtedly will increase.

The proposed expansion of the existing minimum tax provisions also will have far-reaching implications for the municipal market. In determining the alternative minimum tax, the income base now must include interest on certain tax-exempt bonds issued on or after January 1, 1986. As a result, taxpayers who are liable for the alternative minimum tax either will not acquire these bonds, or will demand a much higher yield.

The problems that I have addressed are compounded by the redefinition of essential and nonessential function bonds, the unified volume limitation, the new arbitrage restrictions, and other related provisions that you have already heard about today. State and local governments are being asked to shoulder an increasingly heavy load in meeting our public needs, yet the types of projects that may be financed with tax-exempt obligations has been reduced, and harsh new restrictions are applied to the remainder. If a government issuer is fortunate enough to bring an issue through this maze to the market, it then must confront the problem of finding a purchaser. Small- and middle-sized municipalities may be unable to find any feasible market, while all issuers will be subject to a significant increase in their total borrowing costs. The relative cost to States, counties, and cities resulting from the taxation of their bonds in the manner I have described far exceeds the Federal revenue anticipated from these sources.

I thank you again for the opportunity to testify today.

[The complete prepared statement follows:]

TESTIMONY OF WILLIAM A. HOLBY

of

KING & SPALDING

Atlanta, Georgia

MEMBER, NATIONAL ASSOCIATION OF BOND LAWYERS

before the

BANKING COMMMITTEE

of the

UNITED STATES SENATE

February 6, 1986

TESTIMONY OF WILLIAM A. HOLBY
BEFORE THE UNITED STATES
SENATE BANKING COMMITTEE

February 6, 1986

Mr. Chairman and Members of the Banking Committee, thank you for the opportunity to address you today. My name is William A. Holby, and I am an attorney with the firm of King & Spalding, Atlanta, Georgia. I also am a member of the National Association of Bond Lawyers, an organization of over 2,100 attorneys, most of whom concentrate their practice in the area of state and local government finance. I am pleased to have the opportunity, on behalf of the National Association of Bond Lawyers, to testify before you on the impact of H.R. 3838 on the issuance of municipal bonds by state and local governments.

H.R. 3838, entitled the Tax Reform Act of 1985, introduces a broad panoply of measures that severely impact upon municipal finance. Generally speaking, these measures abolish many forms of traditional tax-exempt financing, and impose burdensome new regulations on all remaining types of state and local government debt. In addition, the Bill attempts to increase federal revenues through the direct and indirect taxation of interest on state and local obligations held by certain individuals and institutions.

These provisions of the Bill make it much more difficult for state and local governments to raise the capital needed for essential public needs, such as schools, roads and prisons. Compared to the adverse financial impact on state, county and city governments, however, the Federal revenue gain from these measures would appear to be nominal.

The National Association of Bond Lawyers, through our President, James W. Perkins of the Palmer & Dodge firm in Boston, Massachusetts, recently submitted to Senator Packwood a series of eight recommendations intended to provide constructive criticism of H.R. 3838. I urge you to read and consider these recommendations:

1. All tax-exempt obligations are divided into two categories -- "essential function" bonds and "nonessential function" bonds. The category of "nonessential" bonds includes obligations issued to finance multifamily rental housing, mass commuting facilities, sewage and solid waste disposal facilities, most facilities for the furnishing of water, student loans and qualified mortgages, as well as small issue industrial development bonds and bonds issued for the benefit of certain non-profit institutions, such as hospitals and universities. As a result, onerous restrictions are imposed upon obligations that serve traditional governmental purposes.

2. A unified volume cap is imposed upon most nonessential function bonds. The volume cap is demonstrably inadequate to meet the needs for traditional public facilities that now are considered "nonessential".

3. The Bill prohibits the use of any portion of nonessential function bonds for incidental purposes. This elimination of the prior ten percent allowance introduces needless rigidity into the issuance of such obligations.

4. The broad category of nonessential function bonds has become subject to numerous rules that previously applied only to industrial development bonds. These restrictions generally do not fit the new areas to which they are applied.

5. H.R. 3838 prohibits the advance refunding of all nonessential function bonds, including bonds issued to finance housing, education, health care and other traditional public purposes which are now considered "nonessential". In addition, advance refunding of essential function bonds is significantly restricted. Advance refundings often permit the reduction of interest costs or the removal of obsolete limitations for the benefit of these acknowledged public purposes.

6. Essential function bonds are subject to rebate requirements designed to eliminate arbitrage-motivated transactions. The inordinate administrative complexities associated with such requirements are not justified, in view of the various other arbitrage restrictions imposed upon these obligations.

7. In general, the arbitrage provisions of the Bill implement exceedingly detailed temporary period allowances, inordinately restrictive methods for yield calculations, and unworkable requirements regulating the early issuance of bonds. These provisions represent the most unwanted, unworkable and complicating features of the Bill.

My testimony today will address NABL Recommendation No. 8, which challenges the introduction of various tax devices that significantly curtail the demand of investors for municipal bonds or otherwise impede financial institutions from performing their vital roles in state and local government finance. In the interest of increasing the tax liability of certain industries, most notably commercial banks and property and casualty insurance companies, the Bill drastically undermines the efficiency of the tax-exempt market. In general, these devices include the following:

(a) the disallowance of the deduction by commercial banks, thrift institutions and certain other financial institutions of all interest expense allocable to the purchase of tax-exempt bonds;

(b) the reduction of the loss reserve deduction for property and casualty insurance companies by a percentage of the tax-exempt income of such companies; and

(c) the taxation of interest on municipal obligations through the Alternative Minimum Tax (either in its general form or as applied to property and casualty insurance companies).

DISALLOWANCE OF INTEREST DEDUCTIONS:

Prior to the enactment of the Tax Equity and Fiscal Responsibility Act of 1982, commercial banks, thrift institutions and certain other financial institutions were permitted to deduct all interest expense, notwithstanding the investment by such institutions in tax-exempt obligations. With the enactment of TEFRA, and the subsequent enactment of the Deficit Reduction Act of 1984, the amount of interest allowable as a deduction with respect to certain financial institution preference items (including interest on indebtedness allocated to the purchase of tax-exempt obligations) was reduced by 20%. The portion of the total interest cost of the financial institution to which this reduction applies is established by multiplying the total interest expense of the institution by a fraction, the numerator of which is the institution's average adjusted basis of tax-exempt obligations for the year, and the denominator of which is the average adjusted basis of the total assets of the institution.

Section 802 of H.R. 3838 amends Section 265 of the Internal Revenue Code to provide that no deduction shall be allowed for that portion of a financial institution's interest expense which is allocable to the purchase or carrying of tax-exempt obligations. For purposes of calculating the nondeductible interest, Section 802 utilizes the TEFRA ratio analysis, as applied to tax-exempt obligations acquired after December 31, 1985.

The House Ways and Means Committee expressed a concern over the harsh effect of these provisions on smaller municipalities, which depend heavily or exclusively on these financial institutions to acquire their obligations. As a result, the Bill excepts from these provisions, through 1988, certain qualified "essential function" obligations, designated by the issuer at the time of issuance, that are acquired by an institution authorized to do business in the state of the issuer. The obligations must either be short-term tax anticipation notes or bonds of less than $3,000,000 issued to provide project financing. No more than $10,000,000 of obligations may be designated each year by the issuer for purposes of these provisions.

Apart from the limited exception described above, the deduction disallowance provisions ignore the significant benefit to state and local governments that results from the permitted deduction of such interest by financial institutions. Banks have long served as a principal purchaser of municipal bonds, particularly short- and intermediate-term bonds. These institutions, however, cannot be expected to invest in obligations that do not maximize profitability, if they are to remain competitive in the banking industry. Obviously, the assets acquired by financial institutions must yield a rate of return higher than the cost of funding such assets. Within this general parameter, alternative investments compete based upon the rate of return. Under current law, municipal obligations present a viable alternative to taxable investments. The elimination of the interest deduction, however, will cause tax-exempt investments to become non-competitive.

Financial institutions are second only to individuals in the purchase of municipal bonds. Eliminating the demand of financial institutions, therefore, should be expected to have a dramatic impact on the municipal market. Individual investors doubtless are able to fill the void created by the elimination of financial institutions, yet not without an increase in the yield required on such bonds. Although the reduction in the total demand for municipal bonds may be accompanied by some reduction in the total volume of such bonds, due to various other modifications relating to tax-exempt financing, a very substantial decrease in total issuance would be required to offset the loss of bank demand; consequently, rates should be expected to increase under any circumstances.

Notably, the most hard-hit by the elimination of financial institutions from the municipal market will be those least able to tolerate the financial trauma. Certainly, virtually all state and local government issuers, including large municipalities, depend heavily upon commercial banks to acquire their obligations. Nonetheless, larger and more sophisticated issuers may find a public market for their more substantial issuances, while small and intermediate sized municipalities may be unable to find a market at all. Traditionally, local financial institutions have been able to address more carefully the credit risks associated with such municipalities and have been able to purchase their obligations at competitive rates. While the three-year transition exceptions may ameliorate in certain respects the impact of these provisions on the smallest of the local issuers, the potential long-term impact is a matter of significant concern to all municipalities.

Similarly, in the context of industrial development bond financing, it is the small business, perhaps the most sympathetic beneficiary of such financing, that relies most heavily on the purchase of these exempt small issues by banks. If such institutions are effectively eliminated from the marketplace, then a public sale of the securities may be the only financing alternative. The issuance expense associated with the public sale of a small principal amount of securities, however, undoubtedly would cause the issuance itself to be economically unfeasible.

The House Ways and Means Committee Report asserts that the disallowance of interest deductions for financial institutions is justified due to the competitive advantage enjoyed by banks over other institutions that are disallowed such interest deductions. In the context of municipal underwriting, for example, brokers and dealers currently are not permitted to deduct any portion of the interest paid to purchase or carry tax-exempt securities. An analysis of the municipal market demonstrates, however, that the leading bond underwriters in the general municipal market are not commercial banks; indeed, even in the context of the underwriting of general obligation bonds and of tax-exempt notes, where such institutions traditionally have played a more substantial role, no competitive advantage is apparent.

A number of explanations may be offered for the present status of commercial banks in the municipal market. For example, by including one commercial bank to participate in an underwriting syndicate, and allowing such a bank to carry the entire issue during the underwriting period, the underwriting syndicate is able to avoid any competitive disadvantage. Furthermore, many such issues are pre-sold, on a negotiated basis, prior to the date of issuance; as a result, carrying charges associated with such an issuance should be negligible. Perhaps most importantly, however, the tax position of dealers and brokers is essentially the same as for banks, under existing tax laws. Existing rulings and court decisions permit dealers to allocate their interest expense in such a fashion that, for tax purposes, such interest expenses are not allocated to the purchase of tax-exempt obligations and, therefore, are deductible. As a result, the impact of H.R. 3838 may be to impose upon banks the very competitive disadvantage that is intended to be removed.

In summary, the disallowance of the interest deduction for financial institutions should be expected to increase borrowing costs for state and local governments, by sharply reducing demand for short- and intermediate-term obligations. Although banks fulfill a vital role with respect to municipalities of all sizes, small and medium-sized issuers likely will experience the greatest difficulty in marketing their issues. This increase of the yields on municipal obligations will result in a financial loss to state and local governments that dramatically exceeds any revenue gain to the Federal government.

PROPERTY AND CASUALTY INSURANCE COMPANIES:

Property and casualty insurance companies are permitted to deduct reserves for losses that have been incurred but not paid. The House Ways and Means Committee determined that, because a portion of such loss reserves may be funded out of tax-exempt income, the deductible portion of such loss reserves should be reduced by a percentage of the tax-exempt income of such companies. As a result, Section 1022 of H.R. 3838 provides that the deductible loss reserves currently permitted for property and casualty insurance companies will be required to be reduced, prior to 1988, by an amount equal to 10% of the interest income earned on municipal bonds purchased after November 15, 1985; the reduction of these deductible underwriting losses is increased to 15% of tax-exempt income beginning in 1988. The implementation of this provision effectively results in the imposition of a 3.6% tax on otherwise tax-exempt interest prior to 1988, and a 5.4% tax on such income thereafter.

The involvement of property and casualty insurers in the municipal market is drastically complicated by the implementation of a special Alternative Minimum Tax applied to such companies. On the theory that the taxable income of property and casualty insurers must bear a certain relationship to the company's net gain from operations, Section 1023 of H.R. 3838 provides that, beginning in 1988, the taxable income of such companies shall be equal to the greater of its regular taxable income or 20/36ths of its net gain from operations. Included in the net gain from operations, however, is income on all tax-exempt bonds acquired after November 15, 1985. For firms subject to this Alternative Minimum Tax, income on municipal obligations purchased after November 15, 1985 will be taxed at the same 20% rate as income from all other sources.

Just as the disallowance of the interest deduction is likely to eliminate banks from the short-term and intermediate-term municipal market, so also will the reduction of the reserve loss deduction and the implementation of this special Alternative Minimum Tax tend to remove insurance companies from the intermediate- and long-term market. As a result, yields on such bonds, which represent the primary involvement of such insurance companies in the municipal market, undoubtedly will increase.

ALTERNATIVE MINIMUM TAX:

Perhaps the most far-reaching implications for the municipal market will result from the proposed expansion of the existing minimum tax provisions. Title V of H.R. 3838, which implements the Alternative Minimum Tax, provides that interest on all nonessential function bonds issued on or after January 1, 1986 will be treated as a preference item, and therefore must be included in the calculation of the Alternative Minimum Tax. Taxpayers will be required to compute their tax liability using both the standard method and also the Alternative Minimum Tax rules. In the second computation, income derived from various tax shelters is included as a portion of taxable income, and a flat 25% rate (representing an increase over the existing 20% rate) is then applied to such taxable income. The taxpayer's liability is the greater of the two calculations.

In determining the Alternative Minimum Tax, the income base includes tax benefits generated by several "preference items" that are not included in the current minimum tax, among which is the interest income on nonessential function bonds issued on or after January 1, 1986. As a result, taxpayers who are liable for the Alternative Minimum Tax are not expected to acquire such nonessential function bonds, but rather will purchase only fully exempt essential function bonds. Only a nominal amount of federal revenue should be expected to be generated as a result of this minimum tax, inasmuch as other tax shelter items will remain available to such taxpayers. The municipal market, however, will be significantly affected by eliminating those taxpayers who are subject to the Alternative Minimum Tax from the municipal market for nonessential function bonds. As is the case with all provisions causing the taxation of otherwise tax-exempt income, the yields required by investors with respect to such municipal obligations will be substantially increased, to the detriment of state and local governments.

CONCLUSION:

My testimony today is not designed to address the many harsh results of H.R. 3838 on state and local governments resulting from the redefinition of essential and nonessential function bonds, the unified volume limitations, the new arbitrage restrictions and other related modifications. All of these provisions, however, compound the problems discussed above. State and local governments are being required to shoulder an increasingly heavy load in meeting our state and local infrastructure needs. Yet states, counties and cities are now facing a reduction in the types of projects that may be financed with tax-exempt obligations, and are subject to onerous new restrictions with respect to those projects that may be financed.

After weaving through the intricacies of H.R. 3838 and bringing an issue to market, state and local governments must confront the perplexing problem of finding a purchaser for their obligations. Small and intermediate sized municipalities, as well as small businesses in the industrial development bond context, may be unable to find any economically feasible market for these obligations. All issuers will be subject to a significant increase in their total borrowing costs. Thus, while the effects of the interest deduction disallowance, the revised tax treatment for property and casualty insurance companies, and the implementation of the Alternative Minimum Tax will serve to generate little additional federal revenue, the consequent cost to state and local governments will be enormous.

Thank you again for the opportunity to present our perspective on the problems presented to state and local governments by H.R. 3838. We sincerely believe that reasonable restraints on the use of tax-exempt financing may be achieved, and pledge our efforts to work with you to accomplish this end.

The **Chairman**. Thank you, Mr. Holby.

Mayor Suarez is now here and we will ask him to come to the witness table. We are also honored today to have Congressman Pepper here to introduce Mayor Suarez.

STATEMENT OF CLAUDE PEPPER, U.S. REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. **Pepper**. Thank you very much, Mr. Chairman and members of the committee. I'm sorry we're a little bit late but as one of your colleagues coming from the great prayer breakfast it's my great honor and privilege to have as a central part of my district in Miami the city of Miami of which we are all very proud.

We have recently had an election and the people have chosen a very distinguished young man to give leadership to our city and he is fulfilling the highest expectations of our people in the quality of vision, in the quality of courage, and the character of the leadership he's supported.

So I'm very proud to be able to present this morning the distinguished mayor of the city of Miami, my friend, the Honorable Xavier Suarez.

The **Chairman**. Thank you, Congressman. We appreciate your taking the time to introduce him.

Mayor Suarez, please proceed, and I will say that anything you could say about this bill couuld not possibly be as bad as these gentlemen have been saying and Councilman Guthman from Atlanta. Everybody is in sympathy. I'm a former mayor who understands a little about municipal finance and so you're in a friendly audience today as far as what H.R. 3838 does to the financing of cities. Please proceed.

STATEMENT OF XAVIER SUAREZ, MAYOR, CITY OF MIAMI, FL

Mr. Suarez. Mr. Chairman, Senators, and particularly my two security blankets today, Congressman Pepper and Senator Mattingly, who have been holding my hand as I came to testify for the first time ever before the Senate, on behalf of the people of Miami who barely elected me to mayor, I want to highlight some of the written testimony already delivered to you and state that my fundamental view is that the tax-exempt status of local government debt is an essential feature of our Federal system inherent in the roles of the three levels of government.

We in Miami are a young city with all city problems. Our ability to borrow unhindered by uncertainty in Federal tax law is crucial to providing housing, transportation, and recreational facilities for our people. We're like a young couple, Mr. Senator, who planning for their first baby has quadruplets instead and the birth is at the same time as they're at the bank borrowing to buy a one-bedroom house. We have refugees or unexpected children. A couple of years ago, one out of every 13 people in our metropolis had arrived within the last 12 months. This took place in a metropolis of almost 2 million people.

I am not here to ask for a Federal dole. I fully understand and agree with your efforts to balance the budget and specifically agree with the elements of the House bill which shift the tax burden from the working poor to the corporations.

My city, together with the other cities, counties, and States, are required to operate on a tight budget, so tight in fact that we provided a surplus cushion which cut in half the overall governmental deficit created by the Federal Government. Were it not for us, inflation would be double its present rate even assuming only a straight line relationship between deficits and the inflation rate. All we want to do is to borrow and only a tiny percent of our assets. Miami's debt-to-equity ratio is less than 2 percent. Our credit rating is AAA. We are subject to market rates and market scrutiny. The last thing we need is uncertainty created by the Federal Government.

HOUSING NEEDS

Our people need housing badly. Over 30,000 are on HUD's waiting list. The waiting period is now 10 years. Before I was mayor I served on the little HUD board and everyone thought I could get them public housing and section 8 certificates. I had to quit after 1 month because of the letters and phone calls that I used to get. Even so, I kept being solicited and kept a secretary busy. Once I got an old lady into a public housing unit and 2 days later she died. The family told me she was very grateful.

Now that I'm mayor, we are ready to use city resources for low-cost housing. In my first 3 months, we already approved the first housing initiative by the city in over 10 years and we're ready to approve a $43.5 million bond issue for resident-owned low-cost housing as opposed to rental housing. We've postponed voting on it twice. We're not so sophisticated that we can spend any percentage of housing bond issues within 30 days of sale. Don't impose that condition on us.

We have no problems with restrictions on advanced refunding other than the simple argument that this is a measure that will curtail our savings against the market and provide the Federal Government no additional revenue.

We also have no problem with any percentage limitation on low-income versus moderate-income housing bonds. I assure you such a restriction is not necessary since local governments learned after great constituent pressure to involve themselves only in low-income housing.

What we do object to is the Federal Government defining for us valid municipal purposes or limiting mixed-use facilities. We know our planning needs. We know how to avoid private sector control of joint ventures with the public sector. We are not looking to make a profit but we need flexibility in financing public purpose amenities.

Since there is no national problem of municipal governments exceeding their boundaries, don't treat us as if we had. The trend is rather in the opposite direction, toward privatization of traditional municipal functions.

Thank you for taking the time to listen to our testimony this morning.

[The complete prepared statement follows:]

UNITED STATES CONFERENCE OF MAYORS
1620 EYE STREET, NORTHWEST
WASHINGTON, D.C. 20006
TELEPHONE (202) 293-7330

TESTIMONY

of

THE HONORABLE XAVIER SUAREZ
MAYOR OF MIAMI, FL

on behalf of

THE U.S. CONFERENCE OF MAYORS

before the

SENATE BANKING COMMITTEE

February 6, 1986

February 6, 1986

The Honorable Xavier L. Suarez of Miami

Testimony before the Senate Banking Committee

Subject: Public Finance Provisions in the House-Passed Tax Bill

My fundamental view is that the tax-exempt status of local government debt is an essential feature of our federal system inherent in the roles of the three levels of government. Therefore, it is not appropriate for federal law to define and restrict and limit the terms and conditions under which the interest on local government debt will be exempt from federal income tax. Local governments do not tax the interest on federal debt. The federal government should not tax the interest on local government debt.

A local political process, a legal process, and a marketplace discipline already impose responsible constraints on public financing.

Political. Tax-exempt financing is approved and defined by elected officials very close to the voters and projects. Voters will not continue to approve Mayors, City Councils and Boards which squander public credit. Many jurisdictions require specific voter approval of tax-exempt bond issues.

Legal. Reporting and procedural requirements are now imposed by federal law. Local legal rules are strict. In Florida, the State Supreme Court must certify all bonds.

Marketplace. Tax-exempt bonds are sold in a competitive and critical marketplace with limited capital resources. This marketplace limits the volume and controls the quality of tax-exempt finance.

However, since the House tax bill does define tax-exempt finance very specifically, I will respond to those specifics.

General Obligation, Public Purpose Bonds. The financing of pulic projects by tax-exempt revenue and general obligation bonds should not be constrained by federal definitions and categories. The 10% or $10 million limitation on the definition of governmental bonds effectively precludes the tax-exempt financing of many public facilities.

Specifically, general obligation bonds; revenue bonds; bonds for water, sewers, solid waste facilities (if available to the general public) and exempt facilities that are publicly-owned should not be subject to:

- percentage limitation on private benefit
- volume caps
- new arbitrage restrictions

Housing. New housing for low-income persons is an intense need in our community. We have received thousands of low-income immigrants and refugees in recent years and we do not have a large, existing housing stock. The newcomers crowded in with friends and relatives. We have been working desperately to encourage new low-cost housing.

In my community, the sunset of mortgage subsidy bonds is a mistake. The volume limits on multi-family rental housing and on mortgage subsidy bonds is unduly restrictive.

I do feel very strongly that all housing that uses public credit should be limited to low-income persons. As a matter of public philosophy, I do not believe public housing resources should benefit the non-needy. If some units in a project must be available to the non-poor in order to make the project possible, I will accept that. But I will insist on limits and will not tolerate abuses.

Non-public bonds. I support an annual volume cap on the following types of bonds:

- non-publicly-owned exempt facilities
- small-issue industrial development bonds and industrial parks
- student loan bonds

This assumes that the termination of small-issue industrial development bonds and student loan bonds will not occur. I believe that tax-exempt industrial development bonds serve a public purpose if limited to small businesses and to distressed areas.

Arbitrage. The House bill excessively restricts arbitrage. I do not support arbitrage abuses nor the use of arbitrage for local government revenue. But in the world, projects do not proceed on schedule and all bonds cannot be sold at the moment the proceeds can be put to use. Moreover, in most cases, arbitrage profits are re-invested in the project, which reduces the total revenue of bond issuance and the tax loss to the federal government.

Market for Bonds. The House bill unreasonably restricts the market for tax-exempt bonds.

I support a minimum tax as an element in tax fairness but interest on tax-exempt securities should be excluded from income subject to a minimum tax.

I support the bank interest deduction for the cost of carrying and purchasing state and local tax-exempt obligations.

Effective Date. The December 31, 1985 effective date in the House tax bill effectively legislates the end of most tax-exempt financing activity for an indefinite time, without the final passage of legislation. Because of the legal uncertainty, bond counsel cannot now issue clean opinions projecting the tax-exempt status of bonds. Local governments cannot now sell bonds.

The first order of business as the Senate considers tax reform is to insist on a realistic prospective effective date so a rational transition can take place.

The CHAIRMAN. Thank you very much, mayor, and I also wanted to report that you are representing the U.S. Conference of Mayors today, in addition to your capacity as mayor. I'd like to say to you what I did to Mr. Guthman representing the National League of Cities, that I think that there is a great lack of understanding in both the House and the Senate, certainly in the House, or they would not have passed provisions of H.R. 3838 which so dramatically affect municipal finance. So I would hope that the U.S. Conference joins with the National League of Cities in starting to contact every Congressman and every Senator to let them know what a dramatic impact this would have on municipal finance and how it would cause increases in the property tax in every municipality across this country.

It's already having an impact and we've heard testimony that the cost of issuing municipal bonds has increased 300 or 400 basis points just because of the threat of this bill going into effect.

I would also warn you—Congressman Pepper introduced you as a young mayor. Be careful. I was a young mayor once and look at me now—no hair left, worn out, tired, no voice, so watch it. You may end up differently than you started out.

Senator Mattingly.

OPENING REMARKS OF SENATOR MATTINGLY

Senator MATTINGLY. Thank you, Mr. Chairman.

Don't believe a word he said about being old and worn out.

I just want to thank you and apologize for being late. Of course, Congressman Pepper, the mayor, myself, and others were at the national prayer breakfast. Quite possibly, if the House Ways and

Means Committee had been at the prayer breakfast last year you all probably wouldn't be here testifying today.

I would like to personally welcome—of course, one of the Georgians has already left, Richard Guthman, a councilman from Atlanta—and Mr. Holby, who's an outstanding and extremely talented bond attorney from King and Spaulding law firm in Atlanta.

I'm going to be submitting a more detailed statement later for the record, but I just want to briefly express my great concern, as has already been expressed, about the effects of H.R. 3838 and what impact it's going to have on capital formation and the ability of American industry to compete in a global economy.

I'm very disturbed by the effects of the House Ways and Means Committee on tax-exempt financing by public service facilities ranging from streets and schools to water and sewers and waste disposal facilities. I think if H.R. 3838 would be enacted in its current form, it would increase the debt service cost involved with all those public facilities.

Very simply, I think this translates into really less service for the State and local level and more likely higher taxes and we all know abuses had occurred in the tax-exempt financing services and most of those abuses though have been taken out by the tax law changes in 1982 and 1984. And at a time when we in the Federal Government are trying to shift more fiscal responsibility to the States and localities, I think it's indefensible to eliminate a cost-effective means of financing public facilities.

Mr. Chairman, just regarding the provisions of H.R. 3838 which really decimate tax-exempt financing of the public service facilities, I have two recommendations. First, I think that the existing law in this area should be retained as we have it right now. Alternatively, the chairmen of the tax-writing committees issue a statement, at a minimum, at least the effective date can be shifted from January 1986 to January 1, 1987. This I think would really eliminate the chilling effect that the House-passed bill is really having on the bond market.

To that end, I will include in the record a letter that I'm sending to Senator Packwood of the Finance Committee and others as it relates to changing that effective date and how the provisions of the House bill particularly adversely affects not only my State but I think other States.

I'd like to thank you very much.

[Senator Mattingly's complete statement follows:]

STATEMENT OF SENATOR MACK MATTINGLY

Mr. Chairman, this morning's hearings which focus on the effects of H.R. 3838 on the tax-exempt financing of public service facilities may be the single most important segment of this entire oversight review. I make this observation because these aspects of the damaging impact of H.R. 3838 have not received sufficient national attention. We, therefore, have an opportunity to inform the Senate concerning the practical difficulties which H.R. 3838, in its present form, poses for the future financing of public facilities at the State and local level.

Under the guise of curbing some alleged abuses in tax-exempt financing, this House-passed tax bill delivers a broadside assault on the entire structure of tax-exempt borrowing utilized by States and localities borrowing for financing all public-service facilities from streets and schools to water systems and waste disposal facilities.

Enacted in its present form, H.R. 3838 will have two major damaging effects on the financial affairs of State, county, and municipal government.

First, it will significantly increase debt service costs involved with all public facilities. H.R. 3838 imposes a vast array of new technical restrictions and conditions applicable to all categories of tax-exempt bonds, including general obligation and traditional revenue bonds, which if not complied with by the issue over the life of a bond can cause an entire bond issue to be denied tax-exempt treatment retroactive to the date of issue. One does not need a graduate degree in finance to understand that investors faced with these uncertainties will demand financial protection in the form of higher interest yields on these bonds. Other provisions of H.R. 3838 expressly deny tax-exempt status to bonds for future financing of such public purposes as pollution control equipment and municipal convention or trade centers. Fully taxable financing for these purposes will drive up debt-service costs significantly—probably as much as 300 basis points.

The House bill is estimated to raise about $3.0 billion in additional Federal revenues from the new restrictions it imposes on tax-exempt bonds. It is conservatively estimated by experts that debt-service costs for traditional volumes of State and municipal bonds will be increased eightfold—roughly $20 to $25 billion in additional borrowing costs for States and because this degree of private use bonds proceeds will cause the bond issue financing the public facility to be taxable and thus not feasible for cost considerations. At this point, I would like to indicate that I will not take the committee's time citing specific examples of the effect of this provision on States and localities. I believe Councilman Guthman's testimony sufficiently highlights the problem and I commend him for his insightful comments.

I, for one, did not come to the Congress to participate in such a counterproductive intervention of Federal policy on State and local affairs. I trust that view is shared by an overwhelming majority in the Senate. I hope, therefore, that these hearings will provide an evidentiary record to support specific recommendations to the Finance Committee for changes in H.R. 3838 which will eliminate its devastating effects on tax-exempt financing of public service facilities. In fact, the best remedy is to retain existing law.

While the broader goal is to do just that—to retain existing law—in the short term, it is imperative that we achieve an agreement between the House and the Senate to change the effective date from January 1, 1986, to January 1, 1987. While I have talked to Senator Packwood about this, I am today sending a letter to him specifically outlining how the House Ways and Means Committee bill adversely affects Georgia. It is not good economics and it is not good politics.

If we pass this tax bill with these cost-inducing impacts on State and local governments, we can fairly be charged by our constituents with having perpetrated a fraud. And to consciously approve revisions in Federal tax law, which increase financing costs for public services, at the same time we are having to shift more fiscal responsibility to States and localities is totally indefensible. Let none of us harbor any doubt but that the responsibility for such an absurd result will be traced directly to us.

Nearly as disturbing as its cost implications for State and local finance are the deadening effects which H.R. 3838 will have on innovation and creativity by these units of government in the delivery of public services.

Over the past decade or so there have been promising accomplishments in the delivery of many basic public services through public-private partnership arrangements. Often the operative mechanism for these arrangements is a long-term agreement for private management on operation of a governmentally owned facility—a bus system, a hospital, food service in public schools. Most, if not all, such commonsense arrangements will be stopped in their tracks by H.R. 3838, will be adversely affected. I would ask that a copy of my letter to Senator Packwood be included as part of the record.

JAKE GARN UTAH CHAIRMAN

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United States Senate

COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
WASHINGTON, D.C. 20510

February 6, 1985

The Honorable Robert Packwood
Chairman
Senate Finance Committee
United States Senate
Washington, D.C. 20510

Dear Bob:

The pending tax reform bill, H.R. 3838 purports to be effective on January 1, 1986, with the result that the Governor and the General Assembly of the State of Georgia are currently blocked in their efforts to pass the State's 1986 Appropriations Bill. The appropriations process requires an allocation between projects that will be financed with available cash and projects that will financed from the proceeds of bonds issued by the State. The problem is that nobody seems to know what the 1986 federal tax law is that governs bonds.

If the State of Georgia must make its appropriations decision based on the assumption that the provisions of H.R. 3838 will ultimately be enacted as written, then it will not be able to issue bonds. A provision of H.R. 3838 requires that 5 percent of bond proceeds be expended within 30 days of the issuance of bonds. That is impossible for the State of Georgia, because of a State constitutional requirement that prohibits the State from entering into contracts with respect to the expenditure of bond proceeds until the bond proceeds are in hand.

Even if the State of Georgia had the luxury of the ignoring the 5 percent expenditure requirement, the provisions of the bill will still make the issuance of bonds more complicated and costly for the State. H.R. 3838 would require that every penny of bond proceeds be expended within three years of the issuance of the bonds or risk tax exemption retroactive to the date of issuance.

While the State does expend substantially all bond proceeds within three years of issuance, thirty projects might be financed in one issue, and it is not unusual for one or more projects to take longer to complete than originally expected. The State can protect against that risk by inserting call provisions into the bonds, but the cost will be higher because of the loss of call protection to the bondholders. However, that cost will be minimal compared to the additional cost that would be sustained as a result of the provision of H.R. 3838 that deprives the State of the benefit of arbitrage profits during that three-year period that the bond proceeds are being expended to pay project costs. If the State loses the arbitrage benefit, it will have to borrow more money to make up for the difference. Furthermore, the interest rate on the State's bonds will be driven up by the provision of H.R. 3838 that denies financial institutions the benefit of an interest deduction to the extent of interest earned on tax exempt bonds.

Some or all of those provisions may ultimately pass Congress, but it is inexcusable for governmental issues to have to comply with them this year. The immediate result to the State of Georgia is higher costs and greater complexity which is being imposed by a bill that has passed only one House of Congress. I, for one, intend to seek changes in the Senate in the bond provisions, and I find it totally unacceptable that the House of Representatives has the ability to even temporarily achieve the results of constitutional enactment simply by passing a bill out of its own chamber. This is not a unitary legislature, and the United State Senate should not stand by and allow the actions of the House to be treated as if they have the force of law.

While I have focused on the immediate concerns of the State of Georgia because they require immediate attention, I am confident that state and local governments throughout this country have similar problems that will be surfacing before long, if they have not already. This tax bill may never pass Congress; if it does it is likely to be substantially modified, and it is not likely to disposed of until summer or fall. Let's not hold state and local governments hostage in the interim.

Sincerely,

The **Chairman**. Thank you, Senator Mattingly.

Mayor Suarez, thank you very much for your appearance here today. Undoubtedly, with our jurisdiction over municipal affairs and housing in this committee, we look forward to seeing you again at sometime in the future.

Congressman Pepper, thank you for coming over.

Mr. **Pepper**. Thank you very much, Senator Garn.

The **Chairman**. Mr. Kezer.

STATEMENT OF RICHARD F. KEZER, SENIOR VICE PRESIDENT, CITIBANK, NEW YORK, ON BEHALF OF THE PUBLIC SECURITIES ASSOCIATION AND DEALER BANK ASSOCIATION

Mr. **Kezer**. Thank you very much.

My name is Richard F. Kezer. I am employed by Citibank in New York. I have been involved in the public securities market since the mid-1950's and I'm here this morning representing the Public Securities Association, which is an association of about 300 commercial and investment banks that underwrite and deal in notes and bonds issued by State and local governments. I am also representing the Dealer Bank Association, which is a group which represents bank dealers.

The market in which State and local governments raise capital for schools, for highways, for hospitals, for airports, and for a host of other purposes, all of which are for public benefit, has been dealt in our judgment a mortal blow by the Tax Reform Act.

ACT WILL INCREASE STATE AND LOCAL TAXES

The act will—and I state this not as an economist but as a person of some practical market judgment—cost the citizens of State and local governments billions of dollars in increased local taxes and user fees while yielding to the Federal Government relatively few, if any, additional revenues.

This act is not an attempt to correct abuses in the municipal market, as you and Senator Mattingly just pointed out. The ghosts of the financings for massage parlors and the private luxury skyboxes still walk through the halls of Treasury, and I say they're ghosts because these and countless other abusive types of financings have been killed by specific limitations in other earlier tax bills.

This Tax Reform Act is not, as some unfortunately still believe, an attempt to stop abuses which, as I've noted, are already moribund. Rather, the act is yet another attempt to establish the precedent that Federal rule should govern every aspect of the issuance of State and local securities.

Now what does the act include? There's so much in it—and you've heard a lot of these points and I'll be somewhat repetitive—but I want to make sure that these points get emphasized.

The bill categorically denies tax exemption for a host of public benefit facilities. These would include pollution control facilities, sports facilities, parking facilities, and convention centers. Borrowing in the capital markets for these facilities would be done on a fully taxable basis and thus would compete directly with corporate America and the Federal Government for investor attention.

The bill seeks to establish the principle that the Federal Government by definition can decide which bonds issued by State and local governments are for essential and which are nonessential functions. These defined nonessential functions include, as we have heard from some of the other witnesses, hospitals, airports, multifamily housing, sewage disposal facilities, solid waste disposal facilities, resource recovery facilities, ports, mass commuting facilities, and water supply systems.

These are so-called nonessential purpose bonds and I don't even like to use that term. I'm falling victim to something which I've heard referred to as semantic infiltration. When you begin to use their terms, you've lost half the battle. It is, unfortunately, the term that is used in the act.

I would also point out that even general obligation and traditional revenue bonds can be deemed nonessential if more than 10 percent of the proceeds are used in private business. For example, a State bond issue for a water project, even if constitutionally authorized through referendum, would be taxable if more than 10 percent of the water were made available to private water companies for distribution to individual consumers.

The bill makes interest paid on nonessential, or what we prefer to call public benefit, bonds subject to an extended Federal alternative minimum tax. The tax would apply to certain investors, therefore tax exemption is a misnomer. Investor liability on the tax may change from year to year, thus in the hands of certain holders partially removing the exemption will significantly raise the interest cost to the issuer.

Other things being equal, the bill will, I believe, create different tiers in the market for State and local securities. The most desirable from a buyer's perspective would be those securities issued prior to January 1, 1986, where the tax-exempt status is certain, at least for the moment. The second tier will be those essential function bonds issued after January 1, 1986, which although tax-exempt at the time of issuance may become subject to retroactive taxation in circumstances over which a bondholder has no control. This added risk means investors will expect higher returns. This will also hit especially hard at the small issuers who will not have the accounting and the legal and the audit staffs to ensure compliance. This is an especially troublesome provision in the bill.

Future violation of one of a number of procedural rules will penalize faultless bondholders of all municipal bonds sold after 1985.

And the third level of this three-tier market will be those securities specifically subject to the alternative minimum tax where there is a definite possibility that they will be taxed in the hands of certain holders.

EFFECTS ON PRIVATIZATION VENTURES

To go on, the bill would put an end to privatization efforts and most public-private cooperative ventures. The bill would impose a statewide volume cap for many categories of issuers. The annual cap per State is the greater of $175 per capita or $200 million with $25 per capita or $30 million reserved for charitable hospitals and colleges, $75 for housing, and $75 for all other affected purposes, including a portion of any bond issue in excess of $1 million used by nongovernmental parties.

That portion of an essential bond between $1 and $10 million of any general obligation must have a cap allocation. The list goes on.

The bill would severely limit the right of issuers to refinance debt to achieve interest rate savings, remove restrictive covenants or restructure debt. It would, under certain circumstances, impose a 100-percent tax on earnings on the interest of bond proceeds invested for a temporary period.

This is a list of some of the changes that are being proposed under the guise of tax reform. These changes, which will result in either higher costs of borrowing or fewer marketable issues, and probably both in some combination, are being proposed at the very time that State and local governments are being asked to shoulder a greater responsibility for the well-being of the citizenry. At the same time, the resources to do that job are, if H.R. 3838 is put into effect, being stripped away.

A recent Washington Post article cited the consequences of the cuts in grants to State and local governments under the Gramm-Rudman budget bill. These cuts will affect programs for highways, for mass transit, for airports, for sewage plants, for education, and on and on—this double whammy effect of increasing responsibility while at the same time taking away a vital tool used successfully by State and local governments, will have consequences that can only be imagined.

What would we at the Public Securities Association and the Dealer Bank Association respectfully suggest as an alternative? Senator Mattingly hit it right on the head. Leave the market alone. Leave the market alone. On 12 separate occasions since 1968 Congress has enacted laws to regulate and limit the use of tax-exempt financing by State and local governments. Since 1980, three major laws have been enacted, making substantial changes in the use of proceeds and establishing elaborate technical rules which must be met to assure continued tax exemption.

If you believe that changes are required, you can regulate abuses without burdening all innocent issuers. Don't issue ration cards to each State capital that at best may or may not bear a resemblance to the particular need in that State. Don't try to distinguish semantically between legitimate public purposes by labeling some essential and others nonessential. Don't burden public issuers with new highly technical prospective requirements. Don't limit the opportunities for public-private partnerships and don't take away or make unnecessarily expensive one last reliable tool by which State and local governments meet legitimate public needs.

Thank you very much.

[The complete prepared statement follows:]

TESTIMONY OF RICHARD F. KEZER
ON BEHALF OF
THE PUBLIC SECURITIES ASSOCIATION
BEFORE THE COMMITTEE ON
BANKING, HOUSING & URBAN AFFAIRS
OF THE
UNITED STATES SENATE

February 6, 1986
Washington, D.C.

TESTIMONY OF RICHARD F. KEZER*
BEFORE THE U.S. SENATE COMMITTEE ON BANKING, HOUSING & URBAN AFFAIRS

INTRODUCTION

The Public Securities Association congratulates the Committee for holding these vital hearings on the impact of the Tax Reform Act of 1985 passed by the House of Representatives on subjects within the jurisdiction of the Committee. My remarks today will address the impact of the House passed measure on the ability of our nation's states, counties, cities and public authorities to finance public benefit projects through the issuance of tax-exempt securities.

PSA believes that this is a particularly inappropriate time for the federal government to impose prohibitions and additional restrictions on the issuance of tax-exempt debt by states and localities. All levels of state and local government are being required to bear increasing responsibility for the well-being of their citizens, while at the same time they are facing severe reductions in the resources available to meet these needs.

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*Mr. Kezer who is Chairman of the Municipal Securities Division of the Public Securities Association is a Senior Vice President of Citicorp Investment Bank.

PSA is the national trade association of banks and securities firms that trade, underwrite and sell state and local government tax-exempt securities. Last year our membership accounted for over 95 percent of the activity in these areas. In addition, PSA represents all major firms and banks active in trading, underwriting and selling mortgage-backed securities and U.S. Government securities.

THE FINANCIAL CHALLENGES CURRENTLY FACING STATE AND LOCAL GOVERNMENTS

The traditional sources of funding for states and localities, taxes, federal grants and user fees are insufficient to meet current needs, let alone future responsibilities. The tax limitation movements in states such as California and Massachusetts, have limited or reduced the base of taxation for most states and localities. Federal grants have been reduced and, with the advent of the Balanced Budget and Emergency Deficit Control Act of 1985 (The Gramm-Rudman Act), we can expect further cuts in the years to come. Typical of these reductions in federal aid are the proposed elimination of revenue sharing and the demise of UDAG grants. While it is certainly appropriate to utilize user fees to pay for public services, such fees often only cover a portion of the cost of public services. Raising such fees to recover the full cost of the service is often inappropriate for public policy reasons (e.g. health care and mass transit).

A host of direct federal aid programs have been slashed including revenue sharing primary and secondary education aid and mass transit. Many programs will be reduced in size or eliminated in the near future as a result of the Gramm-Rudman Act or similar legislation. Three national associations, The Services Employees International Union, The National Council of Senior Citizens and the Villers Foundation, issued a report this week that found that state and local governments could lose as much as $10 billion in 1987 if the automatic cuts mandated by the Gramm-Rudman Act occur. This figure represents a reduction of between 22 to 25 percent in federal programs administered by state and local governments. Consequently, state and local governments will be responsible for providing essential services that were formerly provided by the federal government. In addition, state and local government are being asked to shoulder a larger share of the cost of road, bridges, mass transit and the like.

Faced with these diminishing sources of capital and rapidly increasing level of responsibilities, state and local governments look toward traditional sources of borrowing capital and managing funds. For over a century states and local governments have financed their capital needs through the issuance of tax-exempt securities. The tax-exemption provides state and local governments with a source of low cost capital to meet ever changing public needs. In the nineteenth century construction of the Erie Canal was thought to be a legitimate public purpose. In the era following the Second World War constructing schools for the "baby boom" generation and building the infastructure necessary to support the mass movement to the suburbs was an important public purpose. Today public purpose in Texas may be a charitable health care facility serving the state's growing population; in New York a resource recovery facility to alleviate ecologically unsafe landfills is a public purpose; while in Missouri a low income multi-family rental housing project to provide urban poor with safe and habitable housing is a clear public purpose. By financing the construction of these and other public benefit projects through the issuance of tax-exempt debt a state or locality can lower the cost of providing essential services. Additionally, it can pay for such projects over their useful life. Repayment often is provided by the user of the facilities.

In addition, state and local governments, for economic reasons and often at the behest of federal legislative mandate, will work with private enterprise to provide service to the public. For instance, many mass transit authorities in Massachusetts have long term contracts with private bus carriers to provide bus service. These arrangements are encouraged in the Urban Mass Transit Act. Other examples of this public private partnership range from maintenance of police cars to management of resource recovery facilities to use of private catering services to provide school lunches.

However, the ability of state and local governments to finance public benefit projects through the issuance of tax-exempt securities has come under direct attack in H.R. 3838. This bill would eliminate the issuance of between one-third to two-fifths of the tax-exempt bonds issued, mainly those financing projects using a private public partnership. It would impose new costly restrictions on the issuance of all remaining bonds. Additionally, it would raise financing costs of these bonds by imposing a tax on all bond purchases by banks and property and casualty insurance companies (the largest institutional purchasers of the securities) and would impose the first ever minimum tax on individuals purchasing many types of municipal securities. In short, H.R. 3838 would reduce drastically the ability of states and localities to issue tax-exempt bonds while constantly raising their costs of issuance. This is occuring at precisely the time when these securities are most needed to meet national needs.

Moreover, the market for tax-exempt securities already is reeling from a continuing series of legislative changes. Four times during the past five years the tax laws regarding state and local government securities have been altered fundamentally. For the market to operate efficiently it is imperative that it have time to adjust to the previous changes before additional restrictions are imposed.

THE LEGISLATIVE SETTING

The Tax Reform Act, H.R. 3838 was passed by the U.S. House of Representatives on December 17, 1985. Although yet to be considered by the Senate, H.R. 3838 already has caused a number of tax-exempt note and bond issues to be cancelled and has limited greatly investor interest in the few issues that have come to market.

Some of the confusion is a result of the January 1, 1986 effective date in the House bill. The effective date issue, however, must not obscure the fact that the bill contains many substantive provisions that, if enacted into law, would severely restrict the issuance of all tax-exempt securities, including general obligation and traditional revenue bonds. Make no mistake, the tax-exempt bond restrictions are not limited to alleged abuses. This bill would have an impact on virtually every new tax-exempt bond.

The restrictions concerning the issuance of tax-exempt securities are estimated by the Joint Committee on Taxation to raise approximately $3.1 billion over the next five years. We believe that the revenue estimates of JCT grossly overstate the revenue gains from these provisions. The internationally recognized accounting and consulting firm of Coopers & Lybrand conducted an analysis of the JCT estimates of revenue gains from the original Administration proposal and concluded that the methodology employed to calculate the revenue gain seriously overstated such gain. While H.R. 3838 is different in a number of significant ways from the Administration proposal, the assumption in the JCT analysis were repeated in their analysis of H.R.3838.

However, even if one accepts the revenue gain estimate of JCT, the revenue gain is insubstantial in comparison to the impact of the proposal on state and local governments. PSA believes that H.R. 3838, if enacted, would raise state and local government borrowing costs by a much greater amount than $3.1 billion. We contend that provisions raising the cost of state and local government finance while providing relatively meager revenue to the "revenue neutral" tax reform effort should not be included in a tax reform bill.

In addition, the bill challenges the very concept of tax-exemption. Under the banner of "tax fairness" the bill would levy, for the first time, a minimum tax on individual and corporate purchasers of certain state and local government securities. The bill would effectively end commercial bank investment in state and local obligations by disallowing the deduction for the cost of funds used to purchase or carry tax-exempt securities. Additionally, H.R. 3838 would reduce property and casualty insurance company purchases by limiting permissible loss reserve deductions based on tax-exempt bond holdings as well as imposing a direct minimum tax on certain tax-exempt interest earnings. By imposing these restrictions on the purchasers of tax-exempt bonds H.R. 3838 would raise the cost of state and local government borrowing.

EFFECTIVE DATE

Before addressing the key provisions in the bill, it may be beneficial to review some of the problems that we have encountered during the past five weeks when, in effect, the municipal bond market has been subject to the House passed measure. A number of trends are developing:

1. Due to the requirements of the bill a number of bond issues have been cancelled or postponed. The relevant provisions of H.R. 3838 concern both the manner in which tax-exempt securities may be issued as well as the types of projects that may be financed with tax-exempt bonds.

The State of Georgia was unable to float a bond issue earlier this month due to a requirement in the House passed bill. The state's Constitution requires that proceeds of a bond issue be in hand prior to signing contracts to spend the money raised by that bond issue. However, the House passed measure requires that five percent of the proceeds of a bond issue be spent within thirty days of issuance. Consequently, due to the contradictory requirements of the State Constitution and the House bill the bond issue was postponed.

In addition, the city of Phoenix, Arizona was forced to postpone a lease financing after receiving only one bid. The apparent reason for the lack of investor interest was the perceived insufficiency of the accompanying legal opinion given the new requirements of the House bill.

2. Smaller units of government are experiencing greater difficulties than large nationally known issuers in issuing securities. This is due in large measure to the provision in the House passed bill that would retroactively render taxable securities which do not meet certain requirements for the life of the bonds. Investors and securities dealers have greater confidence in the ability of larger well known issuers to meet these requirements.

In January school districts in Starkville, Mississippi; Garland, Texas and Victoria, Texas among others canceled tax-exempt bond issues due to an inability to attract investors. Burlington, Vermont issued a three month note at a rate of interest 300 basis points (a basis point is .01 percent) higher than anticipated the City Treasurer. So long as the provisions of H.R. 3838 are in effect we expect that other small communities will find themselves either unable to borrow or borrowing at taxable rates of interest. For these local governments the new standard of tax-exemption will in effect be the end of tax-exemption.

3. A three tier market is developing. Tax-exempt bonds subject to the restrictions in H.R. 3838 are perceived as less valuable than those issued prior to 1986. Post-1985 bonds subject to the minimum tax will be less valuable than those bonds not subject to its requirements. Bonds issued this year are being sold at interest rates that are 25 to 50 basis points higher than comparable issues sold in 1985. For a 20 year bond issue of $100 million, this represents an added cost of between $5 and $10 million over the life of the bond issue. Thus far, no bonds subject to the individual minimum tax have been issued.

Thus far this year we have experienced the development of a two tier market caused by traditional investors in municipal securities being unwilling to purchase tax-exempt securities issued in 1986. The largest purchasers of tax-exempt securities are individuals, either as direct purchasers or through unit investment trusts and bond funds. The second largest purchaser of the securities has been commercial banks. Both groups of investors have thus far in 1986 avoided the purchase of bond issued this year.

As noted above, no bonds subject to the minimum tax on individuals and corporations have been issued this year. Thus, the tiering that we are experiencing is related to the impact of proposed restrictions on all bonds (e.g. loss of deductibility on bank purchases of the bonds, as well as the threat of retroactive taxability). We must await issuance of bonds subject to the minimum tax before we can gauge the cost of this provision on states and localities

Our industry trade publication, The Daily Bond Buyer, reported on Monday, January 27, 1986 that yields on pre-1986 bonds were reduced significantly this week; by 20 basis points for revenue bonds and 10 basis points for general obligation bonds. On the other hand, the indices that are representative of the current market paint a different picture. The Bond Buyer 20 bond G.O. index fell by only 5 basis points during the week of January 27 and its 25 bond revenue index dropped only 8 points. While two large competitive bond issues were sold during the week, it is widely believed that they would have been issued at lower rates of interest had the restrictions of H.R. 3838 not been in effect.

This record, and it is only a partial one, compiled in only one month, compels this question: Is it the intent of Congress to prevent schools from being built, needed water projects from being completed, or to raise the cost of borrowing for local and state governmental authorities of all sizes across this country?

That, unfortunately, is the record of January 1986, and all of this has not contributed one penny to the Federal Treasury.

THE FIVE AND TEN PERCENT RULE

The House passed bill would impose a new standard of tax-exemption, the so-called five and ten percent rule. The new standards would mark a profound change in how bonds are issued and the purposes for which they may be issued.

In order to be tax-exempt, less than ten percent, or $10 million, whichever is less, of the proceeds of a bond issue can be used by a non-governmental person. Or alternatively, in order to be tax-exempt, less than five percent, or $5 million, whichever is less, of the proceeds of a bond issue may be loaned to a non-governmental person. The standard permits some exceptions and these bonds, while tax-exempt, are entitled, "non-essential function bonds". Additionally, if the amount of non-governmental "use" or the amount "loaned" to a non-governmental entity exceeds $1 million, that portion of a bond issue -- irrespective of whether its a general obligation bond -- is taxable if not issued pursuant to the state's unified volume cap.

Obviously, the definition of the terms "used" and "loaned" will have a large impact on the effect of the new provision. In the context of the bill the term "used" relates to activities such as leases, concessions, management contracts of longer than a year, operating contracts of longer than a year, and output contracts or take or pay contracts. From the report language accompanying the bill it appears that the term "use" implies any activity carried on by a non-governmental person in a different way than can be carried on by the general public.

The term "loaned" is somewhat narrower in scope than the term "use". Nevertheless, in many instances the definitions will snare the same activities. We will need to wait for bond counsel and the IRS to review these provisions before we get real working definitions of their meaning.

In determining the level of non-governmental use there will no longer be an allowance for nonqualified incidental use of proceeds. This means that all non-governmental uses will be aggregated in determining compliance with the 5 and 10 percent rules as well as the $1 million rule.

It is clear that the new "use" and "loan" standards in conjunction with the aggregation concept would render potentially taxable financings that have long been considered public purpose. For example, in order to finance a city hall with tax-exempt securities all the uses of the structure must be examined. This includes the management of the news stand by a news company, management of the cafeteria by an outside firm, janitorial or gardening services provided by an outside vendor and even the use of the auditorium by outsiders. If the aggregate non-governmental use exceeds 10 percent of the bond issue or $10 million the city hall cannot be financed with tax-exempt securities. If that use is between $1 million and $10 million it is subject to the volume cap.

"Use" as defined in H.R. 3838 can be found in such activities as: management of a service area on a Turnpike by petroleum company franchise, use of the local high school auditorium by a traveling theatre company, leasing of the municipal stadium by a professional sports team or maintenance of street lights by a private company.

"NONESSENTIAL FUNCTION BONDS"

As noted before the House bill does provide some exceptions from the five and ten percent rules. The tax-exemption will be provided to bonds issued for specified purposes irrespective of the percentage of non-governmental use of the bond issue's proceeds. These securities, as noted earlier, have been termed pejoratively in the statute as "nonessential function bonds." The list of these exceptions is as follows:

(1) mortgage revenue bonds;
(2) veterans' housing bonds (which along with mortgage revenue bonds are scheduled to sunset at the end of 1987);
(3) small issue industrial revenue bonds;
(4) bonds for not-for-profit Section 501 (c) (3) organizations such as charitable hospitals and private universities;
(5) student loan bonds;
(6) qualified redevelopment bonds; and
(7) exempt facility bonds.

Exempt facility bonds may be issued for the following purposes:

(1) airports;
(2) ports;
(3) mass commuting facilities, but not mass commuting vehicles;
(4) water distribution, but not for irrigation;
(5) sewers;
(6) solid waste disposal; and finally
(7) low income rental housing.

A wide variety of heretofore exempted activities would lose their tax-exempt status under the House bill. These purposes are as follows:

(1) sports facilities;
(2) convention or trade show facilities;
(3) parking facilities;
(4) facilities for the local furnishing of gas or electricity;
(5) pollution control facilities;
(6) industrial parks; and
(7) mass commuting vehicles.

The nonessential function bonds which are permitted under the House bill to be issued in tax-exempt form are the only exceptions to the five and ten percent rules. However, these bonds are subject to a number of other very important restrictions that will limit the value of the exception.

The most important restriction on nonessential function bonds is the state volume cap. Secondly, with respect to airports, ports, mass commuting facilities and facilities for the furnishing of water, the facilities financed with tax-exempt debt must be owned by a state or local government. This requirement is a direct attack upon the public private partnership concept. The standard is being imposed irrespective of the public benefit being provided. In addition, in the 501 (c) (3) area, the facility being built must be owned by either the not-for-profit organization or by a state or local government.

Thirdly, with respect to ports-and airports the bill and report language is clear in stating that the facilities financed with tax-exempt securities must be directly related to the port or airport. No tax-exempt financing will be available for restaurants, book stores, gift shops or the like.

Fourthly, the bill significantly tightens the requirements for single and multi-family housing financed with tax-exempt securities. However, due to the added complexity of these new requirements there are serious questions with respect to the viability of financing single and multi-family housing with tax-exempt securities.

STATE VOLUME CAPS

The state by state volume cap, however, is the most important restriction on the issuance of so-called "nonessential function bonds". Yet, more importantly, the cap also is applicable to general obligation and traditional revenue bonds. In these instances the cap is applied as follows: If the non-governmental use portion of a G.O. or traditional revenue bond -- within 10 percent or $10 million -- is over $1 million, that part is subject to the state cap. In addition, with respect to the cap, the allowance for nonqualified incidental use of proceeds is no longer applicable.

Aggregation of nonqualified uses can be expected to bring many general obligation and traditional revenue bonds within the cap. It is not difficult to imagine a portion of a typical general obligation bond issue falling under the cap. As discussed earlier, financing a city hall may well be a situation where state cap allocation is necessary. In determining whether a portion of the issue requires cap allocation one must examine all uses of the structure, including the management of the news stand by a news company, management of the cafeteria by an outside firm, janitorial services or gardening services provided by an outside vendor and even the use of the auditorium by outsiders.

If the aggregate non-governmental use exceeds $1 million the city fathers must go to the state and request an allocation from the state's volume cap in order to finance the city hall. In a very real sense, the volume cap is going to jeopardize the independence of cities and towns.

The statewide volume cap is $175 per person with a basement of $200 million for small states. In 1987 after single family housing bonds sunset, the cap will be reduced from $175 per capita to $125. The small state cap, however, will remain at $200 million.

Twenty five dollars of the $175 cap, or $30 million of the $200 million cap is guaranteed for 501 (c) (3) not-for-profit issues. There is a $150 million limit on the amount of tax-exempt debt that any 501 (c) (3) issuer can have outstanding, except for hospitals. While $25 is reserved to these organizations more can be issued from the remaining $150.

Unless overridden by the state legislature -- not the governor -- half of the $150 per capita cap is dedicated to housing. There is also an $6 per capita, or $8 million in small states, set aside for redevelopment financing, where during the past two years the state had more than $25 million worth of such financing.

We estimate that the volume cap would have eliminated over $21 billion of the 501 (c) (3) bonds issued in 1985 and approximately $26 billion of all other so-called nonessential function bonds would not have come to market in 1985.

MINIMUM TAX ON INDIVIDUALS AND CORPORATIONS

It is impossible to measure prospectively the impact of a broad based individual minimum tax on investors in tax-exempt securities. At this time the largest segment of purchasers of municipal securities are individuals, either directly or through bond funds and unit investment trusts (UITs).

The bill would make "nonessential function bonds" one of the tax preference items utilized in calculating the 25 percent minimum tax on individuals and corporations. Enactment of the minimum tax would reduce dramatically direct investor purchase of these securities. Due to potential changes in income mix, investors would not be assured that interest on the bonds would continue to be tax-exempt. Moreover, additional disclosure would be required of bond funds and UITs containing these securities.

We at PSA agree that all citizens and should pay their fair share of taxes. However, we are equally convinced that investors in tax-exempt securities pay the economic equivalent of a tax on their interest income by accepting lower rates of return on these investments. The interest cost differential, which goes to the state or local government issuing the securities, is the benefit of the tax-exemption. By taxing the interest at the federal level, the benefit to state and local governments provided by the tax-exemption would be eliminated.

Moreover, this provision is highly counterproductive. Well-advised taxpayers would manage their alternative minimum tax liability to avoid paying it, in this case by not buying the "nonessential function" bonds that are subject to the tax. Elimination of the demand represented by this substantial segment of the bond market will simply drive up the cost of all "nonessential function" bonds, requiring higher tax-exempt interest payments to taxpayers who do not face an alternative minimum tax situation. The result is, at best, higher costs for projects like solid waste disposal and low-income housing, and quite possibly, the elimination of projects rendered infeasible by higher financing costs.

An additional, but perhaps more important concern, is the impact that this type of a tax would have on our nation's Federalist system of government. We believe that with all the attention focused on the size of the federal budget deficit and the need to reform the tax code, too little time and energy have been devoted to the impact of tax reform on Federalism. PSA is very concerned that enactment of the tax-exempt bond provisions in H.R. 3838 would mark the furthest intrusion of the federal government into the spheres more properly left to the states. It is troubling to note that this incursion is occurring at a time when the states are being asked to assume a growing responsibility for providing for the needs of their citizens.

We cannot beleive that, in terms of intergovernmental relationships, it is the intent of the Congress to create a Federal Government more powerful than ever in our history.

COMMERCIAL BANK IMPACT

We are fearful that the proposal would all but terminate commercial bank purchases of tax-exempt securities. The proposal would eliminate the deduction for commercial banks on interest expenses allocable to tax-exempt interest income. The proposed disallowance applies to all tax-exempt securities purchased by banks after December 31, 1985. The provision would deny banks a deduction on the portion of their cost of funds that bears the same ratio that their adjusted basis in post-1985 tax-exempt bonds bears to the average adjusted basis of all its assets.

Current law permits an 80 percent deduction, previously a full 100 percent deduction was allowed. Whether the abolishment of commercial bank deductibility will be applied eventually to the property and casualty insurance area remains to be seen.

This tax will have a pronounced negative effect on smaller cities and school districts that borrow directly from banks rather than issuing debt in the capital markets. A three year transition rule for small issuers can be expected to ameliorate little of the adverse impact that the bill is already having on small issuers.

PROPERTY AND CASUALTY INSURANCE COMPANY IMPACT

Property and casualty insurance company purchases of tax-exempt securities also would be curtailed under the proposed House bill. H.R. 3838 provides that 10 percent of the interest earned on tax-exempt securities, and other specified investments, must be used to reduce deductible underwriting losses. Beginning in 1988 the applicable percentage would become 15 percent. Given the history of bank deductibility one must wonder whether this percentage is heading to 100 percent.

In addition after 1987 property and casualty insurers will be subject to an alternative tax of 20 percent on their net gains from operations. Interest on tax-exempt obligations acquired on or after November 15, 1985 will be included in this provision.

These proposals come at a most unfortunate time. Property and casualty insurers are at a point in their business cycle where they are ready to return to the tax-exempt bond market after a particularly long hiatus. I also note that the November 15, 1985 effective date marked the conclusion of Ways and Means Committee action on the matter. I find it perplexing that an effective date could come into effect with only a majority of the members of the Ways and Means Committee expressing their approval.

ARBITRAGE RESTRICTIONS

The proposal would impose a host of restrictions on the timing of issuances and the permissible internal structure of financings. Arbitrage earnings are used to reduce the size of bond issues and employed to further the purpose of the state or local government in issuing the bond. As noted with respect to the canceled Georgia bond issue the new rules would require that at least 5 percent of the proceeds of a tax-exempt bond issue be spent within 30 days and that 100 percent be spent within three years.

Perhaps most outrageous is the requirement that nearly all arbitrage earnings must be rebated to the federal government. In addition to this 100 percent tax, the bill requires issuers to monitor all investments related to the bonds to insure that detailed rules regarding limited yield investment are met.

Failure to meet any of the arbitrage requirements at any time would result in retroactive taxability. The tax status of municipal securities traditionally has been determinable at the time of issuance. Bond counsel's statements with respect to the reasonable expectations of the issuer at the time of issuance allowed investors to rely on the tax-exempt status of their investments from the time the securities were issued until they reached maturity or were sold by the investor. However, the new proposed rules would end certainty in this area. We are seeing evidence that the uncertainty inherent in this new standard is causing investors to seek higher rates of return on their investments as protection against the potential taxability of a bond issue.

ADVANCE REFUNDING

The bill would have a severly negative effect on the use of advance refunding. State and local governments use this technique by issuing a second set of bonds and uses the proceeds to pay off the original bond issue, in advance of its maturity date. There are basically two types of advance refundings - a "high-to-low" refunding done to get out from under restrictive covenants contained in the original bond issue documents or to restructure debt to avoid default. Once the second set of bonds is issued to pay off the first set, the restrictive covenants are effectively eliminated (defeased).

In a high-to-low refunding, done to take advantage of interest rate savings, the issuer pays off the original high interest rate bonds as soon as possible.

But, if current interest rates are now higher than the rate being paid on the original bond (low-to-high refundings), the issuer can not achieve savings by calling in and paying off the original low interest bonds. The issuer instead invests the bond proceeds from the second issue in an escrow account and uses the escrow principal and interest to gradually pay off the interest and principal on the original bonds as they become due. The project's revenue stream (i.e., the rates or fees generated by the facility built with the bonds), which was initially pledged to pay off the first issue, goes instead to pay off the second bonds.

The Treasury has established limits on the amount of interest that can be earned on the escrow account. The regulations on yield restrictions require that the escrow account's earnings be limited to the interest rate on the refunding bonds.

The bill would generally prohibit the use of tax-exempt debt to advance refund any nonessential function bonds, including bonds for 501 (c) (3) not-for-profit issuers. These issuers would be unable to take advantage of reductions in interest rates or to restructure debt burdens to meet changing financial needs.

With respect to essential function bonds, the bill would permit their advance refunding subject to a broad number of restrictions and conditions. We expect that the proposal would all but eliminate so-called "low to high" refundings where an issue is refunded to alleviate an overly restrictive covenant or to restructure the debt burden to meet an issuer's worsening financial condition. High to low refundings, which take advantage of declines in interest rate levels, will continue to be permitted. However, due to a number of new restrictions they will be more costly for states and local governments and provide less interest cost savings.

CONCLUSION

The Public Securities Association believes that the provisions in H.R. 3838 concerning tax-exempt securities are overly restrictive and counter productive. As noted before, even using the figures of the Joint Tax Committee the proposal would raise only $3.1 billion for the federal government over five years while costing state and local governments an even greater amount in additional financing costs over the same time period. This is not tax reform, it is simply tax shifting.

On twelve separate occasions since 1968, Congress has enacted laws to restrict and regulate the use of tax-exempt financing by State and local governments. Since 1980 alone, three major laws have been passed making sweeping changes in the use of tax-exempt proceeds and establishing elaborate technical rules which must be met to insure tax-exemption. These rules already have increased substantially both the monetary and social costs of issuing tax-exempt bonds. Now H.R. 3838 threatens to multiply by many times the restrictions, complexities and costs associated with tax-exempt borrowings.

This pattern of constant change coupled with the threat of further, more onerous restrictions, has destabilized the tax-exempt market, causing many borrowers to rush to market precipitously out of fear of the unknown, creating an artificial glut on the market. In this time of enormous fiscal turmoil caused by the federal debt and budget crisis, and by the workings of Gramm-Rudman, all of which are causing major disruptions for state and local governments, it is particularly important to privide some stability in the tax-exempt arena. The wisest and most prudent course for Congress would be to let the market stabilize by not enacting new changes in tax-exemption and to analyze, over several years, the effects of the recent changes, as well as their interaction with the debt reduction process.

Additionally, the virtual demise of tax-exemption would occur just as other sources of state and local government funding are being reduced and they are being asked to shoulder ever growing burdens. Indeed the proposed restrictions go to the manner in which tax-exempt debt may be issued as well as the purposes for which the debt may be issued. H.R.3838 would even impose a tax on the tax exempt interest income of the three largest types of investors in state and local government securities, individuals, banks and property and casualty insurance companies.

We urge the Members of this Committee to work to eliminate the tax-exempt bond provisions from the Tax Reform Act.

The CHAIRMAN. Thank you, sir.

Mr. Tetreault.

STATEMENT OF BERNARD TETREAULT, IMMEDIATE PAST PRESIDENT, ASSOCIATION OF LOCAL HOUSING FINANCE AGENCIES

Mr. TETREAULT. Mr. Chairman and members of the committee, I am Bernard Tetreault, the immediate past president of the Association of Local Housing Finance Agencies [ALHFA]. I am also the executive director of the Housing Opportunities Commission of Montgomery County, MD, a public housing authority, as well as a local housing finance agency.

ALHFA represents over 125 city and county agencies which issue tax-exempt bonds to promote affordable housing. I call your attention to the fact that 75 percent of multifamily bonds were issued by local issuers in 1984, very responsible issuers in Los Angeles, San Francisco, Atlanta, Pittsburgh, Minneapolis-St. Paul, and of course Montgomery County, MD itself.

ALHFA was formed to work together to meet the housing needs of our lower income citizens, a tough job at any time, and getting tougher in today's environment. I'm here today to urge this committee to express its strong concern to the Senate Finance Committee over provisions in H.R. 3838 which will adversely affect the ability of local housing finance agencies to meet the housing needs, both homeownership and rental, of lower-income Americans. I will try, Mr. Chairman, to respect your request to summarize my comments.

BILL WOULD CRIPPLE REMAINING TOOL

Local government's ability to provide direct subsidies for housing those lower income people most in need has been effectively eliminated by the devastating budget cuts in the assisted housing programs over the last 5 years. The House-passed bill will render the only remaining tool—tax-exempt bonds—largely inadequate.

My testimony today will highlight ALHFA's concerns regarding H.R. 3838 and offer a comprehensive set of recommendations intended to improve the targeting of tax-exempt single and multifamily bond programs to lower and moderate-income persons as well as to ensure that the issuers of such bonds functionally control all aspects of the issuance from underwriting through to loan management.

Our principal concern with H.R. 3838 is the fact that it subjects multifamily and single-family housing bonds for the first time to the volume cap applicable to all other industrial development bonds.

The effect of the volume cap and its per capita allocation will have a devastating effect on the ability of local housing finance agencies to meet low- and moderate-income housing needs of Americans.

The association did a survey of our membership of local issuers and I call your attention to that attachment because it shows percentages under the cap of 8, 10, 6, 16, 17 percent of the volume that was issued in 1985. Active issuers will be severely penalized under the cap and inactive issuers will receive allocations that many of them will not be able to use.

H.R. 3838 also permits State legislatures to alter or even eliminate the housing setaside. Our fear is that housing, a basic right and therefore essential, will lose out to other politically popular IDB uses. It is for this reason that we urge this committee in the strongest possible terms to recommend to the Finance Committee that it continue current law exemption from the volume cap for multifamily bonds.

The targeting recommendations contained in ALHFA's proposal—namely, income adjustments for family size, deeper targeting, issuer policy statements, and underwriting and enforcement oversight activities—will have the effect of reducing, but not arbitrarily constraining volume. It will be a workable and responsible volume if carried out in that fashion.

We further recommend that the Single-Family Mortgage Revenue Bond Program be continued under a separate cap as in current law.

We are also concerned with H.R. 3838's imposition of income limits for the Mortgage Revenue Bond Program and that its 1987 sunset date is confirmed. The income limits for many of our local members are unworkable and they will leave many of the agencies unable to implement needed affordable housing programs.

Our proposal recommends codifying congressional intent expressed in the 1984 Tax Act that issuers to the extent practical serve lower income before higher income. In addition, without repeating, we subscribe to the points that were made by previous speakers, and I will not repeat them here.

You will note that our proposal supports the additional targeting restrictions for multifamily projects contained in H.R. 3838. These further restrictions were similar to recommendations which ALHFA and the Council of State Housing Agencies presented to the Ways and Means Committee last summer. We recognize that although additional targeting beyond current law is appropriate, a delicate balance must be struck between attracting private sector involvement in this program and the strong commitment that public purpose be achieved in serving low-income persons.

Tax-exempt financing is not a deep subsidy, but a shallow subsidy; however, tax-exempt financing's shallow subsidy, when linked with other subsidies, as is being done in many jurisdictions around the country, provides a means to an end of serving the poorest of the poor. Greater targeting, workable, responsible, we support, but we want to retain the tax-exempt financing tool. I think that's my bottom line in our testimony.

Thank you very much.

[Complete prepared statement follows:]

ASSOCIATION OF LOCAL HOUSING FINANCE AGENCIES
1101 Connecticut Ave., N.W., Suite 700 • Washington, D.C. 20036 • 202 857-1197

STATEMENT
BY
BERNARD L. TETREAULT
ON BEHALF OF
ASSOCIATION OF LOCAL HOUSING FINANCE AGENCIES
BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
REGARDING
TAX REFORM LEGISLATION'S IMPACT ON
TAX EXEMPT HOUSING FINANCE
FEBRUARY 7, 1986

Mr. Chairman and Members of the Committee:

I am Bernard Tetreault, Immediate Past President of the Association of Local Housing Finance Agencies (ALHFA). I am also Executive Director of the Housing Opportunities Commission in Montgomery County, Maryland.

ALHFA, which represents over 125 city and county agencies which issue tax-exempt bonds to promote affordable housing, was formed three years ago to provide local issuers the opportunity to share with each other and with Members of Congress the nature and variety of programs developed at the local level to meet the housing needs of our lower income citizens.

I am here today to urge this Committee to express its strong concern to the Senate Finance Committee over provisions in HR 3838,the Tax Reform Act of 1985 which will adversely affect the ability of local housing finance agencies to issue tax exempt bonds for single family homeownership and multifamily rental housing.

Local government's ability to provide direct subsidies for housing those lower income people most in need has been effectively eliminated by the devastating budget cuts in the assisted housing programs over the last five years. The House passed bill will render the only remaining tool - tax exempt bonds for meeting low and moderate income housing needs -- largely inadequate. While we understand that Americans are being asked to accept their fair share of cuts in direct Federal assistance programs or tax incentives, local governments, and the public services which they're responsible for, are the only ones being forced to accept reductions in both. This is neither equitable, nor fair.

My testimony today will highlight our concerns regarding HR 3838, and offer in lieu of it a comprehensive set of recommendations intended to improve the targeting of tax exempt single and multifamily bond programs to low and moderate income persons as well as to insure that issuers of such bonds functionally control all aspects of issuance from underwriting through enforcement.

Our principal concern with HR 3838 is the fact that it subjects multifamily and single family housing bonds for the first time to the volume cap applicable to all other Industrial Development Bond uses. Permitted volume is then allocated among states on a per capita basis, with 50 percent of each state's share "set aside" for housing, unless modified by the state legislature.

The effect of the volume cap and its per capita allocation will have a devastating effect on the ability of local housing finance agencies to meet low and moderate income housing needs. A recent survey (attached) of ALHFA members showed that 80 percent of the 50 agencies responding would receive per capita allocations 50 percent or less than their 1985 level of issuance. If past activity is any measure of housing need, and we believe strongly that it is, such reductions will render local programs largely inadequate. Active issuers will be severely penalized while many inactive ones will receive a windfall. As you know, Federal budget cuts since 1981 have reduced direct Federal expenditures for low income housing programs by over 65 percent. The Administration's Fiscal 1987 budget is expected, as it did in Fiscal 1986, to propose that no new housing units be funded. Sharply curtailing the authority of state and local agencies to issue tax exempt housing bonds effectively cuts the only remaining tool.

HR 3838 also permits state legislatures to alter or even eliminate the housing "set aside". Our fear is that housing will loose out at the state level to other, more politically popular IDB uses, such as job-creating "small issues", solid waste disposal facilities or hospital or educational institutions.

It is for these reasons that we urge this Committee, in the strongest possible terms, to recommend to the Finance Committee that it continue current law's exemption from the volume cap for multifamily housing bonds. The targeting recommendations contained in our proposal -- income adjustments for family size, deeper targeting and issuer policy statements and underwriting and enforcement oversight activities -- will have the effect of reducing, but not arbitrarily constraining, volume. We further recommend that the single family Mortgage Revenue Bond program be continued under a separate cap as in current law.

We are also very concerned with HR 3838's imposition of income limits (an overall limit of 115% of median, with 50% limited to those at 90% of median in non-targeted areas, and an upper limit of 140% in targeted areas) for the Mortgage Revenue Bond program and that its 1987 sunset date is confirmed. The income limits in the bill are unworkable and will leave most agencies unable to implement programs for lack of a sufficient number of eligible persons. For example, using the current law's 90 percent of average U.S. home sale price of $89,550, (as reported in mid 1985 by the Census Bureau), at a maximum loan amount of 95%, and at a tax exempt financed interest rate of 10%, the minimum income as a percent of area median income needed to afford such a home is 151%. That is why our proposal recommends codifying Congressional intent expressed in the 1984 Tax Act that issuers to the extent practical serve those of lower income before higher income. In addition, in order to assure program continuity and give agencies the ability to plan and administer responsible Mortage Revenue Bond programs, the 1987 sunset should be lifted.

Other areas of concern with respect to HR 3838 are:

1. Changing the definition of qualified multifamily project period from current law's 10 years or one-half of the term of the bonds to 15 years or the length of the bonds with the longest maturity. This could result in projects having to remain rental for as long as 30 - 40 years, a prospect which will turn developers away from the program. Our proposal recommeds instead the greater of 15 years or one-half the term of the bonds.
2. requiring the rebate of arbitrage profits to Treasury and prohibiting payment of issuance costs from arbitrage are unnecessary changes which will drive up the total amount of bonds to be issued.
3. requiring all proceeds of a multifamily bond to be used for a housing project and all of the proceeds of a Mortgage Revenue Bond to be used for loans. Current law requires 90%/10%, which in the case of multifamily projects allows the financing of related and subordinated recreational and commercial convenience facilities and for Mortgage Revenue Bonds up to 10% of an issue available to cover "good faith errors", i.e. mortgages made to those later found unqualified.

We also share the concerns of others with respect to provisions in HR 3838 generally affecting most other tax exempt bonds.

1. requiring that 5% of an issue be expended in 30 days. This would be unworkable for most housing projects.
2. inclusion of interest income on IDBs as a preference item in the minimum tax calculation
3. generally denying banks a deduction of 80 percent of the interest paid acquiring and carrying tax exempt bonds
4. effective dates for the bond provisions of January 1, 1986, effectively giving them the force of law without the Senate having acted.

You will note that our proposal supports the additional targeting restrictions for multifamily projects contained in HR 3838, i.e. 20 percent of the units available for those at 70 percent of median or 25 percent for those at 80 percent of median. These further restrictions were very similar to recommendations which ALHFA and the Council of State Housing Agencies presented to the Ways and Means Committee last summer. They recognize that although additional targeting beyond current law is appropriate, a delicate balance must be struck between attracting private sector involvement in the program and our strong commitment that public purpose be achieved in serving low income persons. Tax exempt financing is not a deep subsidy, but a shallow one. And while we want to serve the lowest income persons possible there is a point where project financial feasibility precludes serving the poorest of the poor without some additional, deeper form of subsidy.

Finally, ALHFA strongly believes that bond-financed low and and moderate income multifamily housing must enjoy a preferential status in the tax code compared to other forms of real estate. Thus it should be given considerably more favorable depreciation treatment, be exempt for the "at risk" limitation and allow for the deduction of construction period interest. Investment in such property should also be excluded from the passive investment loss limitation in the minimum tax calculation.

We thank you for the opportunity to be heard today. We hope that you agree that our recommendations are responsible and constructive. We urge you to recommend to the Finance Committee that it make them part of the Committee's version of tax reform legislation.

PROPOSED CONTENTS OF LEGISLATION

MORTGAGE REVENUE BONDS
MULTIFAMILY INDUSTRIAL DEVELOPMENT BONDS

All statutory references are to the Internal Revenue Code unless otherwise noted.

I. Volume:

Current Law: Multifamily Industrial Development Bonds are not subject to a volume limitation. Mortgage Revenue Bonds are under a volume limitation based on the greater of $200 million per state or 9% of the three year rolling average of all statewide home mortgage originations.

HR 3838: Establishes a volume cap for all Industrial Development Bond activity of the greater of 175 per capita per state, or $200 million. Of that amount, $25 is reserved for 501 (c) (3) organizations. The balance of $150 contains a "set aside" of 50% ($75 per capita) for single and multifamily bonds, with one-third for single family, one third multifamily and one third discretionary. Each state's amount is divided 50% to the state and 50% to local issuers. The state set aside and the state/local split may be altered by state statute. Unused authority may be carried forward for 3 years.

Proposal: Retain current law for multifamily (uncapped) and single family ($200 million or 9% of three year rolling average.

Comments: Federal budget cuts have reduced the amount of direct Federal expenditures for low and moderate income housing by over 60% since 1981. This makes tax exempt multifamily bonds the only remaining tool for meeting the housing needs of lower income persons. The targeting recommendations inthis proposal as well as the issuer responsibility recommendation will have the effect of limiting volume.

The single family Mortgage Revenue Bond program should be capped as it is in current law. There is no compelling need to modify it.

Allowing the state legislature to override the housing set aside as proposed in HR 3838, will put housing against other, more politically popular uses, with housing the loser. In addition a per capita distribution means a windfall for many states and localities which have not been active users of the program while adversely affecting areas, particularly urban areas with acute housing shortages.

II. Multifamily Housing (Multifamily IDBs)

A. INCOME TARGETING

Current Law: Twenty percent of all units in a project must be rented to households with incomes below 80% of the area median income. The 20% requirement falls to 15% in targeted areas. (Also, while not in the law, Treasury has proposed adding family size adjustments to incomes which will reduce the income limits for 1 -, 2- and 3-person households to 56%, 64% and 72% of area median income.)

HR 3838: Adopts a two tiered approach allowing issuers to choose either:

1. a 75%/25% income mix where 25% of the units must be available to those whose family size adjusted income is 80% or less than area median; or an 80%/20% mix where 20% of the units are rented to those whose family size adjusted income is 70% or less than area median.

2. a 60%/40% mix where 40% of the units must be available to those whose income is 60% or less than area median.

Depreciation treatment on projects in the first tier is 25% better than that for the rest of real estate, and 50% better in the second tier.

Proposal: Adopt the targeting provisions contained in the first tier of HR 3838.

Comment: In order to reach low-income families and still maintain private sector involvement, a delicate balance must be reached. Family size adjustments alone mean 30% and 20% reductions in income eligibility, and therefore rents, for one- and two-person households.

The flexible income targeting approach proposed above will make it possible to serve more low-income households because it is responsive to differences in incomes in local housing market. In urban areas, for example, because household incomes vary substantially, an IDB developer would likely choose to target a smaller percentage of units, 20 percent, to households with incomes under 70% of area median income. This is because there would be higher income households in the area who could afford the higher priced market rate units and therefore make possible the lower rents paid by low-income tenants. In contrast, in many rural areas family incomes are relatively flat, therefore a developer might choose the option of more set aside units because the higher incomes needed to target incomes more deeply were not present in the market.

B. FAMILY SIZE ADJUSTMENTS

Current Law: While no statutory provision is present in the Code, Treasury has proposed regulations that require that HUD Section 8 family size adjustment factors be used for the low-income set-aside units.

HR 3838: Provides statutory authority for family size adjustments using the Section 8 methodology.

Proposal: Language addressing family size adjustments should be codified. A more workable "unit-based" method for family size adjustments, similar to the one used by HUD in implementing the Housing Development Action Grant Program (HODAG), is recommended for IDB-financed rental projects in place of the HUD Section 8 family size requirements. Specifically, family size adjustments would be tied to unit size (based on number of bedrooms) in the following manner:

Size of Family	Size of Unit	"Unit-Based" Income Limit
1 person	efficiency	56% median
2 persons	1 bedroom unit	64% median
4 persons	2 bedroom unit	80% median

In addition, for larger bedroom units the family size would be adjusted upwards to allow income projections and rent levels to be based on a 6-person family for a three-bedroom unit and an 8-person family for a four-bedroom unit. Finally, family size adjustments in low-income, primarily rural areas would be based on the greater of the area median income or the state median income.

Comments: There is a need to make permanent the concept of family size adjustments in the Internal Revenue Code. Their enactment will significantly improve the targeting of units towards lower-income individuals and large families.

The HUD Section 8 system of family size adjustments, designed for a deep rental assistance subsidy program, is wholly inappropriate for low-income units in IDB-financed projects. Under the Section 8 program, a one-person household pays the same rent whether it occupies an efficiency or a one-bedroom unit, a two-person household pays the same rent whether it occupies a one- or two-bedroom unit, and so on -- this is because the Federal government pays the difference between the rent set for the unit and what the household can afford.

In contrast, in the absence of Section 8 subsidies, developers and underwriters of Multifamily IDB projects must be able to closely estimate rent levels by unit size in order to project revenues needed to cover debt service and operating costs. By tying family size adjustments to the size of the unit (number of bedrooms), developers will be able to establish rent levels for units of different sizes without having to predict in advance the size of households which will ultimately rent units in the projects.

C. BEDROOM PROPORTIONALITY

Current Law: None

HR 3838: Retains current law.

Proposal: Add a statutory requirement that a proportionate number of two or more bedroom units in the low-income set-aside units must be equal to or greater than the number of two or more bedrooms units renting at market rates. Limit bedroom proportionality to projects with more than 50 units.

Comment: The proposal would prevent a project owner from using only efficiencies and one bedroom units to meet the low-income set-aside requirements. When coupled with family size adjustment as proposed, these two requirements are significant incentives for the production of two and three bedroom units for low-and moderate-income families.

D. OTHER TAX INCENTIVES FOR MULTIFAMILY RENTAL HOUSING

Current Law: In order to stimulate real estate invesment, including investment in low income housing, Congress has enacted several tax code provisions which give favored treatment to real estate investors. These incentives include:

- Accelerated Cost Recovery System
- Capital Gains Treatment
- Construction Period Interest Deduction
- "At Risk" Exception
- Section 167 (k), Qualified Rehabilitation

HR 3838: Retains each of these incentives although in modified form. It also includes a cap on passive investor losses.

Proposal: Continue low income housing's preferential treatment within the Federal tax code by retaining tax incentives including preferential depreciation treatment for bond-financed projects. exemption from at risk, capital gains treatment, construction period interest deduction and removing the ceiling on passive investor losses and excluding them from the minimum tax.

Comments: Tax exemption alone is not enough subsidy to allow for increased targeting and still retain private sector involvement. Multifamily rental housing for lower income persons is one of the least attractive real estate investments so it needs to enjoy preferential treatment to insure investment.

III. SINGLE FAMILY MORTGAGE REVENUE BONDS (MRBs)

A. SUNSET

Current Law: Tax exemption for MRBs is scheduled to end on December 31, 1987.

HR 3838: Retain current law.

Proposal: Lift the sunset so that the MRB program becomes a permanent part of the tax code.

Comments: Regardless of the economic climate, there will always be a need to assist lower-income citizens attain their first home. With the improvements recommended herein, the MRB program presents itself as a valuable homeownership incentive for young Americans. Further, it is important to note that of all the tax exempt activities, retained in the House Bill, only MRBs remain subject to a sunset.

B. PURCHASE PRICE LIMITS

Current Law: MRB-financed mortgages cannot be used to purchase homes costing more than 110% of the average area purchase price for new and old residences in non-targeted areas, and 120% of the average area purchase price for new and old residences in targeted areas (qualified census tracts and economically distressed areas).

HR 3838: Adopted proposal below

Proposal: Reduce the 110% and 120% of average area purchase price safe harbors to 90% and 110% of the average area purchase price. Include a floor for low-income, primarily rural, areas based upon percent adjustments to the state average purchase price.

Comments: The proposed changes would result in improved income targeting of MRB-financed mortgages. The proposal calls for a 20% reduction in non-targeted areas and a 10% reduction in targeted areas. The smaller adjustment for targeted areas will allow state and local governments to contine to address the special housing needs in economically distressed areas. Utilizing the state average purchase price as a floor in low-income market areas will allow states and local governments to continue to provide mortgage financing of new home construction in rural communities.

C. INCOME TARGETING

Current Law: No income limits. Congressional intent language was added in the Tax Reform Act of 1984 to the effect that state and local issuers "are expected to use their authority to issue qualified mortgage bonds and mortgage credit certificates to the greatest extent feasible (taking into account prevailing interest rates and conditions in the housing market) to assist lower income families to afford home ownership before assisting higher income families."

HR 3838: Adopts restrictions limiting MRB use to applicants whose incomes do not exceed 115% of the greater of state or area median income (140% for one third of the loans made in targeted areas). Further it requires that 50% of all MRB loans be made to applicants whose incomes do not exceed 90% of area median.

Comments: The proposal would codify the requirements that lower income applicants be served before higher income applicants, and would not reduce the flexibility required by fluctuating local markets. The restrictions passed in HR 3838 would effectively eliminate the program in states with relatively low incomes and high housing costs. Purchase price limits in conjunction with a codification of the "lower before higher" mandate has the same effect as income limits.

D. MORTGAGE CREDIT CERTIFICATES (MCC's)

Current Law: Issuers may elect to exchange all or part of tgheir MRB Authority to issue MCC's. MCCs may be issued equal to 20% of each dollar of MRB Authority exchanged. MCCs are subject to MRB targeting. MCCs are non-refundable to taxpayers with no tax liability.

HR 3838: Retains current law.

Proposal: Retain current law

IV. ISSUER RESPONSIBILITIES

A. ANNUAL POLICY STATEMENT

Current Law: In order to issue tax-exempt Mortgage Revenue Bonds (MRBs), issuers must issue an annual statement of policy pursuant to Section 103A (j) 5. No such requirement exists for the issuance of Multifamily Industrial Development bonds (Multifamily IDBs).

HR 3838: Repeals the current law requirement

Proposal: An Annual Policy Statement similar to that now required for MRBs would be required for Multifamily IDBs. It would include language addressing the degree to which housing financed by Multifamily IDBs would serve the housing needs of low- and moderate-income persons.

Comments: Extending the policy statement requirement to all housing bonds would improve the targeting of program benefits and enhance Federal government monitoring of bond issuers so as to ensure compliance with Congressional intent.

B. UNDERWRITING AND ENFORCEMENT STANDARDS

Current Law: None

HR 3838: Retains current law

Proposal: Statutory language would be developed to create minimum standards for issuers regarding functional control of underwriting and enforcement activities to establish state and local housing finance agencies as "ongoing concerns" with the primary objective of eliminating "paper" issuers.

Comment: Such a requirement would mandate that state and local governments follow sound underwriting practices, and monitor housing activity supported by tax-exempt bond financing to ensure that beneficiaries are being adequately served and to help eliminate potential abuses.

V. OTHER PROVISIONS IN HR 3838 OF CONCERN

A. Definition of Qualified Multifamily Project Period.

Current law requires that IDB-financed projects remain rental for the greater of 10 years or one-half the life of the bonds (qualified project period). HR 3838 defines qualified project period as 15 years or the life of the bonds with the longest maturity. Most bonds are issued for periods of 30 years. A requirement that projects remain rental for such a long period of time would be a disincentive for developers.

Proposal: Define qualified project period as the greater of 15 years or one-half the term of the bonds.

B. Requiring all of the Proceeds of a Single or Multifamily Issue to be used for the exempt purpose (i.e. housing).

Current law requires substantially all (i.e. at least 90% of proceeds to be used for the exempt purpose -- a multifamily project or single family mortgages. The balance in a multifamily project may be used for necessary and subordinate recreational facilities or commercial convenience facilities. The balance in a Mortgage Revenue Bond program is used to cover "good faith" errors where a mortgagee is later found ineligible.

Proposal: Retain current law.

C. Requiring Excess Arbitrage Earnings to be Rebated to Treasury and Prohibiting the Funding of Issuance Costs from Arbitrage.

Current law permits excess arbitrage earnings to be plowed back into a multifamily project and thereby become an integral part of project financing. The ability to do so lessens the total amount of an issue. In addition, issuers should be permitted to fund issuance costs from arbitrage in order to avoid an unnecessary financial burden.

Proposal: Retain current law as it relates to arbitrage for multifamily projects.

D. Requiring 5% of Procees to be Used in 30 Days

Current law does not contain this requirement. Since multifamily housing projects and single family Mortgage Revenue Bond programs require considerable lead time for start up purposes, this requirement would be impossible to meet.

Proposal: Retain current law.

E. Including IDB interest as a preference in the alternative minimum tax calculation.

Current law does not treat tax excempt bond interest as income to be included in the minimum tax calculation. In addition to constitutional questions which this issue raises, it is very likely to create difficulties in the marketability of such bonds.

Proposal: Retain current law.

F. Effective Dates

HR 3838 provides for an effective date of January 1, 1986 for the tax exempt bond provisions. This has had the practical effect of precluding local housing finance agencies from bringing bond issues to market, not knowing what provisions of law apply. This is a most unfair situation. Low income housing needs didn't cease to exist on January 1, 1986.

Proposal: Clarify the situation with a statement that tax exempt bond provisions will be effective on the date of enactment or January 1, 1987.

[illegible]

ALHFA Survey on Housing Bond Volume

December 1985

	Agency	1985 (Proj.)		1986 (Proj.)		Population	Allocation	Alloc. as % of Total '85 Activity	Alloc. as % of Total '86 Proj.
		S.F.	M.F.	S.F.	M.F.				
CA	Los Angeles County	53.5	200	50	100	1.1 M	41.3 M	16%	27%
	City of Los Angeles	40	325	40	325	3.0 M	112.5	31%	33%
	CRA of Los Angeles	26	148	26	?	3.1 M	115.6	67%	
	City of Long Beach	38.2	33	35	45	380,000	14.3	20%	18%
	City of San Francisco	42.6	389.6	60	185	700,000	26.3	6%	11%
	Santa Barbara Redev. Auth.	0	0	0	10	78,000	2.9	-	30%
	San Mateo County	0	3.2	10	20	587,000	22.0	73.3%	73%
	Alameda County	60.5	41.8	40	40	1.1 M	41.3	40%	51%
	Contra Costa County	59	75	100	50	700,000	26.3	19%	17%
	City of Hayward	0	67	20	20	98,000	3.7	6%	10%
	Sonoma County	25.3	16	0	9	338,000	12.7	32%	144%
	Sacramento	20	300	30	50	900,000	33.8	11%	43%
	City of Fairfield	17	11	0	10	68,000	2.6	11%	30%
	Yolo County + 3 cities	0	40	?	?	125,000	4.7	13%	
	City of Fremont	0	90.6	0	50	130,000	4.9	5%	10%
	Orange County	59	550	?	?	2.0 M	75.0	12%	
	City of Oakland	23	31	50	75	360,000	13.5	26%	11%
	City of Visalia	44	0	25	0	60,000	2.3	5%	8%
	Santa Clara County	23.0	42.6	24	90	1.3 M	48.8	74%	43%
	City of San Diego	39	169	50	300	950,000	35.6	17%	10%
CO	City of Lakewood	5	12	5	12	125,000	4.7	29%	29%
	Denver	30	72	?	?	510,000	19.1	19%	
	Aurora	12	55	10	?	225,000	8.4	12%	
	Boulder County	12	16	?	?	215,000	8.0	29%	
	El Paso County	15	10	15	20	360,000	13.5	56%	40%
FL	Orange + 2 other cities	23	150	30	100	845,000	31.7	18%	25%
	Broward County	55	300	45	300	1.1 M	41.3	12%	12%
	Pinellas County	25	47	30	25	875,000	32.8	46%	60%
	Escambia County	20	50	20	50	250,000	9.4	13%	13%
	Dade County	56.3	295	60	100	1.73 M	64.7	19%	41%
GA	Atlanta URFA	30	110	30	250	456,000	17.1	12%	6%
	DeKalb County Housing Auth.	15	285.9	40	75	500,000	18.8	6%	17%

(Over)

	Agency	1985 (Proj.)		1986 (Proj.)		Population	Allocation	Alloc. as % of Total '85 Activity	Alloc. as % of Total '86 Proj.
		S.F.	M.F.	S.F.	M.F.				
IL	Cook County	84.9	32	85	35	2.3 M	86.3	74%	72%
LA	East Baton Rouge MFA	26	0	26	0	390,000	14.6	58%	58%
MD	Montgomery County	50	235	50	150	625,000	23.4	8%	12%
	Prince George's County	39	200	40	170	670,000	25.1	10%	12%
MN	Minneapolis	30	200	16	100	370,000	13.9	6%	12%
	St. Paul	8.5	55	8.5	40	270,000	10.1	16%	20%
PA	City of Pittsburgh URA	15	8	35	12	423,000	15.9	70%	34%
	Allegheny County RFA	61.7	26	62	50	1.4 M	52.5	60%	47%
	Montgomery County HRA	0	25.8	0	85	650,000	24.4	92%	29%
	Dauphin County	6.4	25	?	22	179,000	6.7	23%	
TN	Memphis Health, Ed. & Housing Fac. Bd.	0	78	0	?	700,000	26.3	33%	
TX	El Paso Housing Fin. Corp.	42.5	38.7	42.5	25	425,000	15.9	20%	24%
	Heart of TX Housing Fin. Corp.	21	22	0	25	147,000	5.5	14%	24%
	SE TX Housing Fin. Corp.	90	60	90	70	950,000	35.6	24%	23%
	Tarrant Co. Housing Fin. Corp.	48	85	?	?	1.0 M	37.5	29%	
UT	City of Ogden	0	5	.2	4	65,000	2.4	40%	50%
VA	Fairfax County	.8	55	.8	75	650,000	24.4	43%	32%

The **Chairman**. Thank you very much. Senator Sasser.

Senator **Sasser**. Thank you, Mr. Chairman.

Gentlemen, as I look at the House bill, I agree that the 10-percent private benefit rule could create and will create problems. It seems to me that we're creating more problems for ourselves whenever we start coming up with new definitions in what is admittedly a rather complex area of the Tax Code. Now I believe we can get away from some of the problems inherent in deciding what is a governmental use and what is a nongovernmental use and what's essential and what's not essential.

Historically, we've maintained that if a project met a public purpose, tax-exempt financing was available.

In your opinion, would we be better served moving away from the multitude of bond definitions we have come up with over the past few years, moving toward a straightforward, across-the-board rule based on a public purpose definition?

Who'd like to address that question?

Mr. **Tetreault**. I would, Bernie Tetreault, immediate past president of ALHFA.

DEFINING PUBLIC PURPOSE IS DIFFICULT

It is very difficult to come up with a definition for strong public purpose at the Federal level. We find in our association, members from Florida have significantly different needs and demands and housing objectives that they're trying to meet than the city of Pittsburgh, for instance, but both can use the vehicle of tax-exempt financing to meet those needs in their local jurisdictions. So I think you need to be strong in your direction to say that these bonds should be targeted, but you can't be specific to a nit at the Federal level. It's just impossible to write something that applies throughout the country.

Mr. **Kezer**. I think that defining public purpose is very difficult. I think people have been trying to do it for years, and I think it varies from maybe one part of the country to the other. It also probably changes over time. Education now is viewed as public purpose. I think perhaps 200 years ago, that might not have been the case.

I would respectfully suggest that instead of trying to fix up H.R. 3838, which is almost beyond redemption, that you start with existing law, the Tax Code under section 103, and if you think that there are inappropriate uses or further abuses, fix that up.

Mr. **Alter**. Senator, I would just like to repeat a comment that I made in my earlier testimony, and that is, if we really believe in the concept that government is best when it is closest to the people, then you simply are going to have to allow those municipal authorities closest to the people to decide their own priorities, and it certainly is not up to the next town, or the next county, or the next State or the Federal Government to decide in a given community that water, or sewer, or education, or any other purpose is the most vital need of the community. I think it's got to be left up to the local authorities, and they've got to have enough flexibility to deal with that.

Senator **Sasser**. Let me ask one broad question of this panel. If you had to vote today on whether to adopt the House-passed tax bill or not, how would you vote? [Laughter.]

Mr. **Kezer**. It's not a fair question. [Laughter.]

Senator **Sasser**. Go ahead, Mr. Alter.

Mr. **Alter**. Could I try that and not be facetious, but, frankly, this bill is being sold to the public on the basis that they are going to receive incremental tax reductions, but just the tax-exempt provisions of H.R. 3838 will come around like a boomerang creating substantially higher costs to local governments who will have to pass it on in the terms of either income tax or property tax with an inefficiency factor of between $5 and $10 to $1. So for every $1 that gets saved in this bill in your incremental tax rate, it is going to eventually cost you $5 or $10 more because of the inefficiencies built into the municipal finance by this bill.

As all of our municipal obligations become taxable, that simply has to be passed on. You can call sewer and water nonessential, if that definition makes you happy, but that doesn't mean that the mayor doesn't have to do it, and it doesn't mean that that project doesn't eventually have to be carried out if at taxable rates and those expenses will be passed on.

So the answer is, it's really a disaster, and if given a choice, we'd have to vote against the whole bill.

Senator **Sasser**. Gentlemen, thank you. Thank you, Mr. Chairman.

The **Chairman**. Senator Heinz.

OPENING STATEMENT OF SENATOR JOHN HEINZ

Senator **Heinz**. Mr. Chairman, the Banking Committee's hearings today focus on the effect of the House's tax reform bill on State and local governments and housing. Today's hearing may be the most important of the series.

Decent, affordable housing for all Americans has long been a valued national goal. Through our Tax Code and through the passage of legislation creating programs to encourage or provide housing Congress has shown its dedication to helping our citizens realize the dream of homeownership. For the less fortunate we have attempted to pursue policies that would at least guarantee adequate shelter.

Community development, most importantly redevelopment of our blighted urban areas, is another area in which the Federal Government has been strong in its support. As a country, we have decided not to let our cities decay and we have been successful in revitalizing some previously blighted areas.

The last few years have seen a steady erosion in our Housing and Community Development Programs. The budget presented by the President yesterday reveals even greater reductions in the HUD budget. Together after the cuts proposed by the President, H.R. 3838 would represent a complete reversal of our national commitment to ensure adequate housing and to keep our cities livable.

The mayors and councilmen who are protesting the changes to the tax-exempt bond guidelines are pleading to be allowed to continue to provide their towns and cities with the facilities they need to survive and to grow without Federal help. With the Federal Government turning off the flow of Federal assistance as we have already seen with the cutbacks of revenue sharing, we must not also cut off the cities ability to help themselves.

The key to revitalization of our cities and provisions of housing for low-income individuals in recent years has been the ability of local governments to issue tax-exempt bonds. What may be considered to be nonessential to Washington, may not be nonessential to a community in the Monongahela Valley—and I think that within reasonable guidelines the community should have the ability to decide that issue.

Other provisions of the House bill simply defy explanation. The requirement that bond proceeds be spent within 30 days of issuance indicates that members of the Ways and Means Committee never dealt with a contractor. The requirement that arbitrage proceeds be rebated to the Federal Government will only result in municipalities issuing tax-exempt bonds in greater amounts. The annual volume cap imposed from Washington indicates that the Ways and Means Committee can better decide local needs than can the localities. These are not productive restrictions. They tie the hands of local governments so they cannot help themselves.

As a member of the Senate Finance Committee I recognize that we have far to go in formulating a new tax reform bill from our existing Tax Code. I would like to assure our witnesses of my determination that the Senate bill will not be a copy of the House bill.

As a member of the Finance Committee, I am not unfamiliar with the concerns. Some of you, I think, were there this summer giving us the benefit of your views on this subject, and the Finance Committee is, indeed, having hearings at this moment, and as a member of that committee, I am going to return there shortly.

I must say that I am, like Senator Mattingly and others on this panel, quite concerned that—particularly as we cut back on the sources of other aid to cities, localities, counties, that in addition—and we all know that revenue sharing has already become a substantial casualty of those cutbacks, that it is highly likely that there will be other funding reductions, either made by the Congress or made by Gramm-Rudman. We prefer the Congress. The changes proposed in H.R. 3838 in conjunction with those other cutbacks would, I think, cripple the ability of the private sector and the public sector to provide the kinds of opportunities for housing, redevelopment, and urban improvement that we clearly need.

There has already been a considerable amount of confusion inflicted on the bond market by the provisions of H.R. 3838. I understand Senator Garn asked the first panel about that, so I won't repeat that question.

I would like to ask just one further followup. I may have missed an answer to an earlier question, but is there any narrowing of the definition of public purpose bonds that we should do, from where they are today?

[No response.]

It's a very quiet group.

The CHAIRMAN. Any volunteers?

DEFINITION NARROWED ON PUBLIC PURPOSE BONDS

Mr. **Herlinger**. Senator, I think I would restrict my comments to the housing arena, and over the past 3 years, there has been a steady stream of legislation that narrowed that definition and that provided additional targeting that was required and additional reporting requirements that were required. My answer, at least on the housing side, would be no, leave it where it is.

Senator **Heinz**. Mr. Henikoff, you are concerned about the $25 per capita cap, are you?

Mr. **Henikoff**. Yes.

Senator **Heinz**. Has anybody asked you any questions about that?

Mr. **Henikoff**. No.

Senator **Heinz**. Good. [Laughter.]

Because in Pennsylvania, it's a particular problem. We have a very large State-related university system, for example, and our hospitals have the same problem, but we have a very large State-related university population, but they are not State universities, yet they are expected to do many of the kinds of things State universities do. The University of Pittsburgh is State related, but it's not a part of the university, Penn State. The University of Pennsylvania in Philadelphia is, in fact, an Ivy League school. It's a private school with State relations, the same as Temple University is more like the University of Pittsburgh, and so forth.

And what would you anticipate would happen at institutions like that, if the $25 cap was retained?

Mr. **Henikoff**. Well, I am particularly glad that you asked, because for 5 years I was dean of Temple University Medical School. [Laughter.]

Senator **Heinz**. What a coincidence! [Laughter.]

Mr. **Henikoff**. Temple University's hospital facilities were tremendously outmoded, and many of them did not meet the safety code. A new hospital of close to 500 beds, by the way, which had a reduction in the number of beds rather than an increase, will be opening next month, I believe. I've been away for almost 2 years.

I would say, Senator, that that building would not have been built if these current proposed restrictions at a $25 per capita cap were in place. The various ramifications of cost of tax-exempt financing under H.R. 3838, if it were available at all, would be too expensive for the university, and I think that a seriously aging facility would not have been replaced.

Senator **Heinz**. So what would have happened? Would we have been denied necessary health care in Philadelphia?

Mr. **Henikoff**. Ultimately under H.R. 3838—I would like to get away from the Temple example—I think that the country will be denied health care, because of the advance refunding provision, for example. If the advance refunding were not available, certain mergers could not take place. In the city of Chicago currently there is a proposed merger that is being studied between two of the largest institutions in the city. That kind of merger can be negated by having advance refunding unavailable, just because of the restrictive covenants that are existing in bonds that are out and are not callable at present.

Some mergers are going to have to take place as the rest of the environment of the health care industry is undergoing changes. This is going to reduce the number of beds available in the country, and that is positive in mergers such as this. However, if a hospital can't merge, it may fail, and that's a very unattractive alternative.

Senator HEINZ. Thank you.

The CHAIRMAN. Senator Mattingly.

Senator MATTINGLY. Just one comment. I know there will be a lot of people coming forward here to testify on H.R. 3838, as they will before the Finance Committee, and one recommendation I would make, even though it's fun to come testify, that I think the biggest problem we've got right now is the January 1, 1986, date, and I would recommend everybody who has come before us, prior to this, now and the future, the best thing you can do is probably write dear Rosty a letter or go over there to the House side and see if we can't get that date changed. The instability that it's causing is the biggest problem I think that you all have right here and that we have right now.

REVISION IMPERATIVE ON JANUARY 1, 1986 DATE

So my recommendation would be, you know, as I am writing Packwood or we're writing these other people that we go to the House side and see if we can't get these two parties together to make certain this date is changed now, because it's not going to do any good, if we keep on continuing to testify on H.R. 3838, we'll still be getting torpedoed by the January 1, 1986 date.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Mattingly.

Mr. ALTER. Could I comment on that?

The CHAIRMAN. Yes.

Mr. ALTER. My legislature is currently in session and has another 3 weeks to consider a statute to appropriately put an allocation process for the cap in place. Right now, the legislature doesn't know what to suggest. Bond council is divided in their advice. The Governor, frankly, doesn't want the hot potato dividing and allocating this scarce resource, and everyone's in a quandry as to exactly how to handle it. Yet something has to be done. Existing provisions referred to by our current cap legislation disappear under the new legislation. They have to be replaced with new provisions. A system needs to be put into place or we're out of business in the meantime, and yet no one knows how to handle it. It's a terrible dilemma and a catch-22 situation that should never be imposed on the States.

Senator MATTINGLY. Right. I think when the House put the January 1986 date in earlier last year, they thought they would use it as leverage, because it would help the Senate pass a tax bill, but when they didn't give it to us until I think, what, late November or December, it was too late then. They should have taken the provision out. But you know, we need to get that expedited and get it accomplished now.

Mr. ALTER. We're trying to devise a statute which will be effective, should the bill become effective, but disappears if the bill never passes and is still effective in the meantime. That's a Herculean task.

Senator MATTINGLY. Yes, I bet.

The CHAIRMAN. Actually, the really sad thing is that the President resurrected that turkey in the House. The whole thing should have been killed, not just the effective date.

Senator MATTINGLY. It's amazing what can happen when you don't vote. [Laughter.]

The CHAIRMAN. So gentlemen, you are going to be spared from further questions, because my doctor told me if I ever want to get rid of this, to quit talking. [Laughter.]

And that is virtually impossible. That is our profession over on this side, but I am trying to minimize it. So possibly we will have some additional questions for you to respond to in writing.

Thank you very much.

The CHAIRMAN. Our third panel today is composed of John Koelemij, president, Orange State Construction Co., Tallahassee, FL, immediate past president, National Association of Home Builders; G.V. "Mike" Brenneman, Jr., chairman, legislative committee, National Association of Realtors; Ronald F. Poe, president, Dorman & Wilson, Inc., White Plains, NY, on behalf of the Mortgage Bankers Association; Robert F. Sherman, president, S&S Properties, Inc., Dallas, TX, president, National Apartment Association; and Stephen D. Driesler, executive vice president, National Multi Housing Council.

Mr. Koelemij, would you like to begin, please.

STATEMENT OF JOHN KOELEMIJ, PRESIDENT, ORANGE STATE CONSTRUCTION CO., TALLAHASSEE, FL, ON BEHALF OF NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. KOELEMIJ. Thank you, Mr. Chairman. If I may take a point of personal privilege, I think I speak for all the panel when I say that we have reason to be proud of what you did last week. It was not an easy task and I know how close you were to the happening at Cape Canaveral and I just want to thank you for taking on all of that.

The CHAIRMAN. Thank you. That's very kind of you. I've got one more difficult task to perform this afternoon. There is a memorial service for Mike Smith where they are going to present his astronaut wings to his widow and promote him to Captain posthumously, so I have to speak at that service. So I've got one more difficult task, but thank you for your remarks.

Mr. KOELEMIJ. Mr. Chairman and members of the committee, thank you for the opportunity to appear before you today. I believe it is very significant that this committee has decided to look seriously at the impact of tax legislation on areas of the economy within your jurisdiction. For surely it is the responsibility of this committee to advise the Finance Committee on the impact of its potential actions on housing.

My name is John Koelemij and I am immediate past president of NAHB, which represents over 137,000 members. I have thought a good deal about how to present a coherent view of tax policy toward housing in 5 minutes. Instead of shrugging my shoulders and giving up, I decided to get back to basics.

TWO-THIRDS OF HOUSEHOLDS OWN THEIR HOMES

I am sure you are all aware, but in today's climate it bears repeating, that housing is a basic human need. For the past 50 years, you in Congress and every successive administration has recognized the social, political, and economic impact of improving housing supply and quality. And we—in partnership between the private sector and all levels of government—have made tremendous strides. Today, nearly two-thirds of all households own their homes. And the percentage of households living in inadequate housing has declined considerably.

But some tend to forget that one of the major links that forged that housing miracle—which is the envy of the world—was the traditional favorable treatment of housing in the Tax Code.

Many of us could not afford the home we currently own without the ability to deduct interest on the mortgage or local property taxes. Millions of homebuyers would have been priced out of the market without the availability of mortgage revenue bond financing for firsttime buyers. This is truly a pro-family housing policy. As the President said on Tuesday night:

> Family and community remain the moral core of our society, guardians of our values and hopes for the future. Family and community are the co-stars of this great American comeback.

For the past 3 years, housing has brought America back—economically through encouraging long-term investment, creating jobs, and restoring the American dream. That is the rationale for the basic housing policy embodied in the Tax Code—deductibility of mortgage interest and property tax, favorable depreciation schedules, and a variety of incentives which promote housing production.

But as a society we recognize that more has to be done—as the President said, "to help in time of need * * * to create a ladder of opportunity * * * to provide shelter and nourishment for those who cannot provide for themselves."

It is important to recognize that rental housing has become essentially low- and moderate-income housing. In 1983, the median income of renter households was $12,800, compared with $24,400 for homeowner households. The rent burden for low-income households is already very heavy. Those renter households with incomes below $10,000 in 1983 paid an average of almost 50 percent of their incomes for rent.

It is these families who would suffer the most under the House-passed tax bill. Sadly, the limited tax savings such households would gain under the bill would be far outweighed by monthly increases in rent.

At the same time, we face a serious problem of maintenance and retention of the assisted housing stock—the 3.3-million units constructed or rehabilitated specifically as low-income housing. Some of these units need major renovation, others face the end of the term of Federal assistance, and some may be taken out of the low-income housing stock. Clearly, any special tax treatment of low-income housing will have a significant impact on our ability to retain this essential stock of housing for those in need.

And, finally, in my travels across the country these past 4 years as a NAHB senior officer, I have been impressed by the restored vitality of our older cities and the center-city development throughout the country—revitalizing deteriorating downtown areas, restoring the tax base, stimulating local economies, and once again making our cities the showplace of talent, ideas, and fun they were meant to be. Who would have thought it possible even 10 years ago when burned out buildings and planned shrinkage were the order of the day? It was the risktakers of a free enterprise system—with the assistance of Federal tax credits for rehabilitation and historic preservation—that brought us back.

Mr. Chairman, my written statement goes into great detail about specific provisions and impacts of the House-passed bill. I urge you and your staff to review it. And I urge you to continue to work with our competent technical staff to analyze and understand the intricacies of the proposed tax bill.

I truly appreciate this opportunity to reflect on what we as a nation have accomplished before any hasty rush to judgment to enact tax reform. I think you will agree that as you craft a housing agenda for the future, the Tax Code must continue to be a critical element in shaping national economic and social policy.

I would be pleased to continue this vital discussion and answer any questions you may have.

[The complete prepared statement follows:]

STATEMENT OF
THE NATIONAL ASSOCIATION OF HOME BUILDERS
before the
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
on
IMPACT OF H.R.3838 ON HOUSING
February 6, 1986

Mr. Chairman and Members of the Committee:

My name is John Koelemij and it is an honor to appear before you today as Immediate Past President of the National Association of Home Builders (NAHB), representing more than 137,000 members.

Mr. Chairman, it is very appropriate that your Committee is examining the potential impact of tax reform on housing. As you know, housing and urban development programs have been cut drastically in recent years. In fact, those cuts have been so deep that the Internal Revenue Code of 1954, as amended, is now the major instrument of Federal housing policy. Before you enact the "Internal Revenue Code of 1985", it is, thus, imperative that this Committee examine very closely the potential impact of proposed tax reform on housing.

This statement provides a brief overview (Part I) of the concerns of housing with tax reform, followed by a more detailed statement of the impact of proposed tax reform on single-family housing (Part II) and multifamily housing (Part III), a discussion of provisions that would affect both single-family and multifamily housing (Part IV), and a discussion of the economic impact of proposed tax reform on housing (Part V).

I. Overview

The Federal Government has, for a long time, been committed to encouraging housing and has used tax policy as a significant and conscious instrument of Federal policy to attain housing goals. Homeowners have relied on the deductibility of mortgage interest and property taxes to help them achieve home ownership, and renters have benefited from the tax incentives provided for individuals to invest in rental housing. This tax policy has made possible increased rates of home ownership, a comfortable standard of housing for most households, and a steady decline in the amount of substandard housing.

Affordable rental housing is an essential part of our social policy today. Rental housing must be available for those who are unable financially, or who do not desire, to own their own home. As I will explain, further, rental housing would not be an attractive investment without tax incentives. Absent tax incentives, the availability of rental housing would decline and the cost to renters would increase.

Because of the effect of tax policy upon housing and housing policy, tax revisions should not be viewed in isolation from other changes in housing policy and programs. Housing and urban development programs already have been cut by over 60% since 1980. Given the enormous reductions in housing related programs since 1980, this is simply not fair or responsive to the growing needs of lower income families and the elderly. Because of this reduction in direct spending for housing programs, it is clear that housing policy now has shifted to the tax writing committees. It is also clear that given this policy making shift and due to the proposed tax law changes, this Committee should remain involved in the debate over housing policy.

Tax policy is of major importance to those who construct housing, to those who finance housing, and, thus, to those who reside in housing. We need a consistent tax policy that maintains our national commitment to affordable, quality housing -- both for home ownership and for rental housing. A consistent policy of support for decent housing and home ownership has been a national commitment for more than fifty years. This principle should be a priority in any tax policy.

Enactment of H.R.3838, as passed by the House of Representatives would have a profound effect upon individuals and businesses, particularly those involved in housing, as well as on home buyers, home owners, and renters. In fact, H.R.3838 represents a fundamental change in the philosophy and objectives of taxation affecting many areas of the economy, and these effects must be weighed carefully before proceeding with tax reform.

H.R.3838 would have an adverse effect on both single-family housing and multifamily housing.

With respect to single-family housing, we are pleased that the House agreed to retain the deduction for State and local real property taxes and the mortgage interest deduction for up to two personal residences. We also are encouraged by the fact that the House agreed to continue the mortgage revenue bond program, at least through 1987. However, we are concerned with the following provisions of H.R.3838, related to single-family housing:

o The bill would place substantial new limitations on mortgage revenue bonds, as well as subject them to a much stricter volume cap.

o The bill would treat loans for which installment obligations are pledged as security as payments on the pledged obligations. This would severely restrict the utility of homeowner bond (builder bond) financing.

o The bill would provide that taxpayers who itemize their deductions (generally home owners) would be limited to a $1,500 personal exemption, while all other taxpayers would be entitled to a $2,000 personal exemption. Moreover, by increasing the standard deduction to an amount substantially above the deductible non-housing expenses of most households, it would reduce the effective value of deductions for the expenses of home ownership.

NAHB estimates that single-family housing starts would decline by about 110,000 units in the first year after enactment of H.R.3838. (Part V discusses the likely economic impact of H.R.3838.)

Likewise, the impact of H.R.3838 on multifamily housing would be quite dramatic. We are concerned with the following provisions:

o The bill would lengthen the depreciable lives for most residential buildings from 19 years to 30 years, and change the depreciation method from 175% declining balance to straight line.

o The bill would provide several new restrictions for multi-family industrial development bonds, as well as subject them to a strict volume limitation.

o The bill would limit the amount of interest expense that could be deducted by a "passive investor" (e.g., a limited partner) to $20,000 per year ($10,000 for a single taxpayer).

o The bill would repeal the provision of present law that allows construction period interest and taxes to be deducted over a 10-year period. Instead, these amount. generally would have to be recovered over the property's depreciable life (i.e., 30 years for most buildings).

o The bill would reduce the capital gains deduction from 60 percent to 50 percent in 1986 and, further, to 42 percent in 1987. This would increase the top individual income tax rate on capital gains from 20 percent to approximately 22 percent.

o The bill provides special incentives for investment in "very low-income" housing (i.e., projects where at least 40% of the units are set aside for families earning 60% or less of average area median income). However, we are concerned that the definition of very low-income housing may be so restrictive as to render those incentives meaningless.

NAHB estimates that multifamily housing starts would decline by about 50% in each of the first two years after enactment of H.R.3838. (These findings are discussed more fully in Part V.)

In addition, there are other provisions of H.R.3838 that would have an impact upon both single-family and multifamily housing. Two of the most significant of these provisions deal with the individual minimum tax and contributions in aid of construction:

o The bill would increase the top individual minimum tax rate from 20 percent to 25 percent. In addition, it would broadly expand the minimum tax base to include, among other items, certain "passive activity" losses (e.g., limited partnership losses), and interest on tax-exempt nongovernmental obligations (e.g., mortgage revenue bonds and multifamily industrial development bonds).

o The bill would repeal the provision of present law that provides for the treatment of contributions in aid of construction received by public utilities as nontaxable contributions to the capital of the utilities. The effect of this provision would be to cause contributions in aid of construction to be taxable and, thus, to increase the cost of housing through higher costs for infrastructure development (e.g., water and sewer systems).

We also are very concerned about effective dates. Most of the provisions of H.R.3838 would take effect on January 1, 1986, with "grandfather" relief for certain projects underway as of September 25, 1985. Because it is not clear when tax reform legislation will be enacted, we are concerned that the effective dates in the House bill will cause serious disruption in the marketplace and have an adverse impact on investment decisions during 1986. In fact, uncertainty about tax reform already has caused major problems for the tax-exempt bond market. Thus, we urge that the effective date of any final tax reform legislation be no earlier than January 1, 1987, with appropriate "grandfather" rules for projects underway prior to the end of 1986.

Attachment A to this statement summarizes those provisions of H.R.3838 that would have an impact on housing. Attachment B compares the House bill to the original Ways and Means Committee options, the President's proposals, and present law.

II. Single-Family Housing

Several important tax incentives have been established for owner-occupied housing. These include the mortgage interest deduction, the deduction for real property taxes, the deferral of capital gains taxation on the sale of a home, and the one-time exclusion for capital gains of up to $125,000 on the sale of a personal residence for individuals who are age 55 or over.

The President's tax reform proposals would have repealed the deduction for State and local taxes (including real property taxes), and would have sharply limited the amount of interest expense that could be deducted with respect to mortgages on second homes.

The House bill retains full deductibility of State and local taxes. We urge that the Senate bill do likewise. At a minimum, however, we urge the Senate to maintain the deduction for real property taxes. Next to the mortgage interest deduction, the deduction for real property taxes is a key factor in making home ownership affordable.

While the House bill would cut back on the amount of investment interest and consumer interest expenses that could be deducted, it would permit full deductibility of interest on debt secured by the taxpayer's principal residence and on a second home. This provision reflects the belief of the House that encouraging home ownership is an important policy goal, achieved in part by providing a deduction for residential mortgage interest. This provision also rocognizes the important role that second homes play in the economies of many communities and the importance of this deduction for middle-income households. We urge the Senate to reaffirm this policy by adopting a provision regarding deductibility of residential mortgage interest that is no more restrictive than the provision contained in the House bill.

Notwithstanding the improvements made by the House to the President's tax reform proposals, we still are concerned with the fact that the House bill would drive up the cost of home ownership, particularly for first-time home buyers. Our primary concerns about the House bill's impact on home ownership stem from the House bill's treatment of mortgage revenue bonds, pledges of installment obligations, and personal exemptions.

Mortgage Revenue Bonds

Mortgage revenue bonds have made housing more affordable by allowing State and local housing finance agencies to convert tax-exempt funds borrowed at low interest rates into mortgages that are typically 2 percentage points or more below the conventional mortgage rate. More than one million low-and moderate-income Americans have bought homes with assistance from the single-family mortgage revenue bond program since the early 1970's.

. Since 1980, loans funded by mortgage revenue bonds have been restricted by Federal law generally to first-time buyers of modestly-priced homes. In addition, these loans may be targeted to economically-distressed areas, and most State and local issuers impose income limits.

NAHB was dismayed when the President proposed to repeal the mortgage revenue bond program because it has been an effective means of providing affordable financing to households who otherwise would be unable to achieve homeownership.

We are pleased that the House bill retains mortgage revenue bond financing. However, we feel that the Senate should examine, closely, the changes that are proposed to be made to the mortgage revenue bond program, in order to assure that the program will continue to be workable.

Under present law, at least 90% of mortgage revenue bond ("MRB") proceeds must be used to finance homes of first-time home buyers, and the purchase price of MRB-financed homes may not exceed 110% of the average area purchase price (120% in targeted areas).

The House bill would modify the MRB targeting requirements generally as follows:

o all bond proceeds must be used to finance homes of first-time home buyers;

o the purchase price of MRB-financed homes could not exceed 90% (110% in targeted areas) of the average area purchase price; and

o at least 50% of MRB loans must be made available to borrowers whose family income does not exceed 90% of area median income, and all loans must be made available to borrowers whose income does not exceed 115% of area median income.

In addition, the House bill would subject MRBs to a much tighter volume cap than that under present law, and would allow the MRB program to "sunset" at the end of 1987.

NAHB does not object, in general, to stricter targeting requirements. We agree with the House that there should be standards designed to assure that MRB loans are provided to low- and moderate-income first-time home buyers. However, these standards should not be so restrictive as to undermine the viability of the MRB program.

In particular, NAHB is concerned with the requirement that at least 50% of MRB loans be provided to borrowers whose family income does not exceed 90% of area median income. We are concerned that in times of high interest rates, when MRB financing is needed most, it may be quite difficult, if not impossible, to meet this set-aside requirement. Thus, rather than providing for a national standard that all areas of the country must meet, we would urge the Senate to consider providing the State and local housing agencies with the leeway to provide more flexible income limitations based upon particular housing needs. Most states already have established income restrictions for their MRB programs.

A major problem with the House bill is the volume limitation it would impose on MRBs. Currently, MRBs are subject to a separate annual volume limit that is the greater of 9% of the average annual aggregate principal amount of mortgages executed during the three preceding years for single-family, owner-occupied residences located within the State, or $200 million. The House bill would provide a new, unified volume limitation for most so-called "nonessential function" bonds (that is, MRBs, multifamily industrial development bonds, bonds for mass commuting facilities, student loan bonds, small-issue bonds, etc.). Thus, MRBs, which now have their own separate volume cap, would be lumped together with all other competing uses.

The current limit on MRBs, based on recent mortgage lending in each State, reflects the level of housing need. The per capita restriction under H.R.3838 would have very adverse impacts in fast-growing States with large numbers of first-time home buyers.

The annual State volume limitation, under the House bill, would be equal to the greater of (1) $175 per capita (reduced to

$125 in 1988 to reflect the "sunset" of MRBs), or (2) $200 million. A portion of each State's volume limitation ($25 per capita) would be set aside for tax-exempt organizations. Unless overridden by State statute, at least 50% of the portion of each State's annual volume limitation not reserved for tax-exempt organizations would be required to be set aside for housing uses (initially, one-third for MRBs, one-third for multifamily industrial development bonds, and one-third at the State's discretion). Thus, what starts out as a minimal allocation (minimum of $25 per State per capita and maximum of $50 per State per capita) is subject to further cutbacks if other tax-exempt bond uses can more successfully plead their cases at the State level.

We feel that including MRBs in a single unified volume cap would result in a severe reduction of MRB-financed homes, and, thus, would reduce the number of affordably-priced homes for first-time home buyers. According to the Council of State Housing Agencies, the House bill would result in approximately a 47% reduction in MRB activity compared to 1985 levels. We feel that this type of housing policy makes no sense, particularly when you consider the fact that home ownership among young families has been on the decline for the last five years. Since 1980, there has been a 5 percent decline in home ownership for families with heads of household aged 30-35.

Thus, with regard to the volume limitation, because serving the need of moderate-income individuals is an important activity, there should be a separate volume limitation for MRBs.

Finally, because of the worthy goals served by the MRB program, and the need for stability and continuity of housing policy, we urge your consideration of its extension beyond 1987.

Pledges of Installment Obligations

In general, the House bill would provide that when an installment obligation is pledged as security for borrowed money, the borrowed money would be treated as cash received in the year of the pledge.

Simply put, this provision would negate the effectiveness of the homeowner bond (builder bond) program, which has served as a unique tool to address the problem of affordably-priced homes during times of high mortgage interest rates.

Homeowner bonds were developed as a financing mechanism in response to the recession of the late 1970's and early 1980's, which drove about 30% of all home builders out of business. There was a critical need for a new source of mortgage funds, at that time, and homeowner bonds were a private sector response. Homeowner bonds continue to be an important source of capital for the production of affordably-priced homes, primarily for moderate-income home buyers.

Unlike a "traditionally-financed" home sale in which the builder receives cash at closing, under a homeowner bond program, the builder sells homes under the installment method of accounting, receives down payments on the homes, and takes back mortgages on the homes. The builder then receives regular principal and interest payments until the mortgage is retired. Because the builder receives only a portion of the purchase price each year, like any other person who sells on the installment basis, the builder's early year tax liability is lower than for the traditionally-financed builder. However, the builder who uses the installment method of accounting will pay greater taxes in later years as the installment payments are received.

Builders who use homeowner bond financing use the mortgages on homes they have built and sold as collateral for bonds that are issued to obtain capital for additional home construction. Builders then take back the mortgages on these new homes and use them as collateral for future bond issues. The proceeds of these future issues are, in turn, used to provide financing for additional homes. Interest on homeower bonds, unlike mortgage revenue bonds, is fully taxable to the holders of the bonds.

Homeowner bonds have allowed home builders to tap directly into the national capital markets to provide home buyer financing. The development of homeowner bonds has led institutional investors to show an unprecedented willingness to channel their capital into housing. In addition, because of the builder's direct access to major credit markets and through the use of the installment sale method of accounting, builders can provide affordably priced and financed housing through the use of homeowner bond financing.

Studies have demonstrated that homeowner bond financing can save buyers more than a full percentage point in the interest rate. A saving of only 1% on a 30-year mortgage on an $80,000 home will produce savings of nearly $25,000 over the life of the mortgage. While many home owners pay off their mortgages over the full term of the mortgage, the average 30-year mortgage is paid off in 12 years. For a buyer of an $80,000 home, which is paid off in 12 years, a 1% reduction in interst rates produces nearly $9,000 in savings.

While homeowner bond financing is not restricted, specifically, to moderate-income, first-time home buyers, it has been used primarily by large volume builders offering FHA and VA loans. (Small- and medium-sized builders, who do not have adequate size to issue the bonds themselves, are able to use this financing mechanism by pooling their mortgages together in a cooperative manner.) First-time homebuyers in the $18,000 to $40,000 income range have benefitted the most from homeowner bond financing. Moreover, the majority of the homes built under the homeowner bond program cost $80,000 or less, a price range typically available to first-time home buyers.

Although the House bill's treatment of pledged receivables would have a drastic impact on homeowner bonds, the issue goes far beyond that. With an exception for notes payable within a 9-month period, the bill essentially would tax borrowed money if the borrowing is secured by the pledging of an installment obligation. It is one thing to tax the sale of an installment note. In that case, something of value has been exchanged for cash or other valuable consideration. However, in the case of a pledge, there has been no exchange. Rather, something of value merely has been pledged in order to secure a loan. Borrowed money never has been taxed under our legal system because of the borrower's underlying obligation to repay the principal, as well as interest, over time.

If this provision is enacted, we wonder how long it will be before other types of borrowing are taxed. For example, how long will it be before some fertile mind decides to tax home equity loans on the theory that a homeowner has exchanged the equity in his home for cash? The next "logical" step, of course, would be simply to tax borrowed money without having to resort to the theory of an exchange or a pledge to support taxation.

The House bill goes beyond attacking direct pledges of installment obligations. It also brings within its ambit certain "indirect pledges." Under the House bill, an installment obligation is treated as pledged as security for indebtedness if it is reasonable to expect that the lender took into account payments on the installment obligation as a source for any portion of the payments required on the indebtedness. This provision will be troublesome for any business that sells products over a term longer than 9 months, that does not have substantial assets other than installment obligations, and that is not highly liquid.

We urge the Senate to examine this provision very carefully. It does not just affect home builders who use homeowner bond financing, it potentially affects all businesses involved in other than cash sales.

Because of the provision's impact, and due to the dangerous precedent it would establish, we hope that the Senate will not include this provision in its tax reform bill. However, if there is a revenue concern, there are several options available. For example, a small "excise" tax could be imposed on gross installment sales. Alternatively, the tax deferral available through installment sales could be reduced somewhat. NAHB would be pleased to work with the Senate to explore these and other possible sources of revenue.

Personal Exemptions

The House bill would provide a $2,000 personal exemption for each individual, individual's spouse, and each dependent. However, for individuals who itemize deductions, the bill would impose a floor under itemized deductions equal to $500 times the number of personal exemptions claimed. The practical effect of this provision would be to provide itemizers with a personal exemption of $1,500 and nonitemizers with a personal exemption of $2,000.

Since most itemizers are homeowners, we feel that this provision would discriminate against homeowners and, at least indirectly, discourage home ownership. Thus, we urge that at whatever level the Senate decides to fix the personal exemption, it be the same for all taxpayers whether or not they itemize deductions.

III. Multifamily Housing

Tax incentives attracting investment capital have been the lifeblood of the rental housing market, which serves one third of all American households, including the poor who cannot afford to own their own homes. Without tax incentives to encourage the private sector to build rental housing, the Federal Government's obligation to assist low-income Americans in obtaining housing would have to be far greater than it is today.

The taxation of investment in rental housing is complex. Different provisions in the Internal Revenue Code affect a variety of participants in the development process: developers, builders, and investors. The major tax provisions that have affected rental housing include:

- o The accelerated cost recovery system (ACRS depreciation).
- o Rehabilitation tax credits.
- o Capital gains exclusion.
- o Forms of ownership that allow for "flow-through" taxation as a way to attract capital.
- o Exemption from the "at-risk" rules.
- o 10-year amortization for construction period interest and taxes.
- o Tax-exempt industrial development bonds for multifamily housing.

The House bill made several improvements to the President's tax reform proposals in the area of multifamily housing. For example, the House bill retains the rehabilitation tax credit and the provision allowing 60-month amortization for low-income housing rehabilitation expenses, with some modifications. Because of the importance of these provisions in revitalizing our nation's cities, we urge the Senate to follow the lead of the House.

Furthermore, the House bill retains capital gains treatment for sales or dispositions of buildings, retains the present law recapture rules, and retains a partial at-risk exemption for real estate activities.

Clearly, the preservation of capital gains treatment for buildings is crucial. Without it, the price for selling a building would be so high that many investors would be discouraged from investing in the first place. Moreover, it would create somewhat of an anomolous situation to treat the sale of a building as taxable at ordinary income rates while the underlying land would qualify for capital gains treatment.

Almost as important as preserving capital gains treatment for buildings is the preservation of the present law recapture rules. Under those rules, gain on the sale of a building is treated as ordinary income to the extent that accelerated depreciation deductions exceed the deductions that would have been allowable under the straight-line method. Under the President's proposal, all prior depreciation deductions (even if the straight-line method is used) would have to be recaptured. Thus, due to the price that would have to be paid on the back end, many investors would not invest in the first place.

Finally, the House bill is superior to the President's tax reform proposals in that it retains tax-exempt bond financing for multifamily housing, and it provides additional incentives for investment in low-income housing (but not for investment in residential housing generally). However, there are problems, discussed below, with both of these provisions.

Notwithstanding the fact that the House made some improvements to the President's tax reform proposals, there are still major problems concerning depreciation deductions, multifamily industrial development bonds, deductions for "nonbusiness interest," and construction period interest and taxes. These, and other problems, are discussed below.

NAHB is concerned that the changes in the current tax law rules proposed by the House bill would severely disadvantage investment in rental housing compared to other types of investment alternatives. The history of recent tax legislation affecting residential structures has been a progressive diminution of the tax benefits associated with this type of investment. One need only look to the Deficit Reduction Act of 1984 for evidence of this. Among the many significant items in DEFRA affecting real estate investments were provisions that:

o Increased the recovery period for real property (other than low-income housing) from 15 years to 18 years;

o Imposed immediate recapture of depreciation in installment sales;

o Restricted issuance and use of industrial development bonds;

o Expanded the original issue discount rules to cover sales of property;

o Limited deductions of start-up costs for new ventures;

o Severely restricted the benefits from "privatization" of real property;

o Imposed higher test and imputed interest rates on transactions involving deferred payment sales of property;

o Expanded the rules relating to amortization of construction period interest and taxes; and

o Eliminated tax-free exchanges of partnership interests, and tightened up generally in the area of partnership taxation.

Depreciation deductions

From an investment point of view, rental housing often has been unattractive. Intensive management is necessary both to maintain rental housing and to assure a steady stream of income. The cost of maintenance of rental property has increased considerably in recent years. Furthermore, income generated from rental property is lower than for other types of property.

Residential rents generally do not provide for CPI inflation increases, and the income of residents can support only a certain level of rent. Accordingly, market rents generally do not create an income stream that is competitive with other types of investments. Moreover, rent controls in many jurisdictions have kept rents at below market levels.

These are the reasons that residential housing must retain generous depreciation allowances in order to be competitive with other types of investments. A major reduction in present depreciation allowances would drive capital away from residential housing at a time when more, rather than less, capital is needed.

In 1981, NAHB supported ACRS depreciation because of its certainty and simplicity. However, it is a misconception to believe that ACRS significantly increased depreciation deductions for new residential construction. In fact, under the law prior to the 1981 Tax Act, component depreciation plus the ability to use the double declining balance method of depreciation sometimes provided a more advantageous depreciation situation for new housing than was the situation after ACRS. Component depreciation often provided larger total depreciation deductions over the first six years than does ACRS.

The House bill would substantially alter depreciation allowances for rental property by replacing ACRS with the so-called Incentive Depreciation System ("IDS"). Under IDS, the recovery period for most buildings would be increased from 19 years to 30 years. In addition, the only depreciation method allowable for most buildings would be the straight-line method.

A simple example will help to illustrate the impact of this proposed change for most buildings. Using the Treasury Department's 9 percent discount rate, and assuming a sale after 12 years, the present value of depreciation deductions under the House bill (30-year, straight-line) are reduced by about one-half from present law (19-year, 175% declining balance). Assuming a $1,000 cost basis, the present value of the depreciation deductions under current law is $458. The present value of those deductions under the House bill would be only $236. The present value of the tax savings from depreciation deductions, assuming a 35-percent tax rate, would be $160 under current law (i.e., $458x.35) and only $83 under the House bill (i.e., 236x.35).

We are pleased that the House bill, at least, provides an additional incentive for investment in low-income housing. Under the bill, low-income housing would also be depreciated over a 30-year period, but use of the double declining balance would be permitted. Thus, the depreciation allowance would be about 25 percent more generous than depreciation for other structures. Low-income housing eligible for this method of depreciation would be projects that are financed with industrial development bonds or projects which meet the industrial development bond targeting requirements described below.

The House bill also carves out for special treatment so-called "very low-income housing." That type of housing would be assigned a 20-year recovery period and could be depreciated under the double declining balance method. Thus, the depreciation deductions would be about 50 percent greater than depreciation deductions for rental housing that does not qualify as low-income housing.

In order to qualify as very low-income housing, at least 40 percent or more of the units must be occupied by households whose income is 60 percent or less (for a 4 person household) of median gross income. While we are pleased that the House bill recognizes the need to provide an additional incentive for investment in very low-income housing, we are troubled by the fact that the extent of the extra incentive is probably not adequate to stimulate construction for the very low-income group, without the provision of additional, direct subsidies.

Beginning in 1988, the House bill would provide a partial inflation adjustment for IDS deductions. In general, IDS deductions would be increased by one-half of the inflation rate in excess of 5 percent. We recognize that this provision would provide taxpayers with at least some protection against loss of real value in depreciation deductions due to excessive inflation. However, we would suggest that the same goal could be accomplished, with greater simplicity, by providing shorter depreciable lives.

With regard to depreciation, we would urge the Senate to adopt a system which compensates for the risk of investing in residential rental property. Furthermore, we would urge that the Senate provide an additional incentive for low-income housing that will not require direct subsidies to make investment in such housing feasible.

Industrial Development Bonds for Multifamily Housing

Even though current tax law provides several incentives for investment in rental housing, it generally is not feasible to construct new rental housing for low-and moderate-income households at rents they can afford, given current costs and interest rates. In recent years, virtually new rental housing for low-and moderate-income households has been financed with state and local industrial development bonds ("IDBs") often in tandem with Federal rent subsidies. These IDBs provide debt financing at rates that are 200 basis points or more below conventinal mortgage rates.

In 1984, IDB financing of rental housing totaled about $5 billion and provided financing for about 100,000 new rental units, accounting for about 25% of new rental units in structures of 5 or more units. For 1985, total IDB financing was in the neighborhood of $11 billion, accounting for about 200,000 units or approximately 50% of rental units in structures with 5 or more units.

In order to qualify for tax-exempt IDB financing for multi-family housing, at least 20 percent of the housing units must be set aside for tenants with low-or moderate-income. However, for certain targeted area projects, this set-aside requirement is reduced to 15 percent. A targeted area is a census tract in which 70 percent or more of the families have incomes that are 80 percent or less of the applicable statewide median family income, or an area of chronic economic distress. The set-aside requirement must be satisfied continuously during the qualified project period (generally, a minimum of ten years).

The determination of whether individuals qualify as low-or moderate-income individuals is made by reference to the rules under section 8 of the Housing Act of 1937 for determination of lower-income families, except that the percentage of family median gross income that qualifies as low or moderate is 80 percent. Until this year, there was no requirement in Treasury Regulations that adjustments in family size had to be made in the applicable percentage of median gross income to determine whether a multi-family IDB qualifies for tax exemption. However, this is now a requirement for IDBs issued after December 31, 1985.

Bonds that are issued to finance multifamily residential rental property are under fewer restrictions than apply to other types of IDBs. Multifamily IDBs are not subject to the state volume limitations that were placed on other tax-exempt private acitivity bonds in the Deficit Reduction Act of 1984. IDBs for multifamily housing also received exceptions from other restrictions placed on IDBs by the Deficit Reduction Act of 1984, including additional arbitrage restrictions, a prohibition on Federal guarantees of tax-exempt bonds, and a requirement that cost recovery deductions be determined using the straight-line method rather than full ACRS deductions.

The more liberal treatment accorded multifamily rental IDBs vis-a-vis other tax-exempt bonds reflects the important public purpose served by tax-exempt rental financing.

IDB financing has become a real necessity to the rental housing market in this era of high real and marginal interest rates. Using the NAHB computer model of an investment in rental housing, we estimate that IDB financing permits a project to "pencil out" or be economically feasible at rents which are 12 percent lower than with conventional financing. These lower rents are translated into below-market rents on set-aside units for qualifying households, generally lower rents and greater availability of moderate income housing, or into meeting special targeting goals of the state or local housing finance agency.

Absent tax incentives, a large portion of the nation's substantial demand for rental shelter would go unmet. As it is, renters' shelter costs have risen significantly over the past decade. According to the Census Bureau and HUD, the cost of rent, utilities, and fuel accounted for 29 percent of renters' median family income in 1983, up from 22 percent in 1973.

The House bill would make several significant changes to multifamily IDBs. First, the targeting requirements would generally provide the following:

o 25 percent or more of the IDB-financed units must be rented to families whose income is 80% or less of area median income, adjusted for family size, or

o 20 percent or more of the units must be rented to families whose income is 70 percent or less of area median income, adjusted for family size.

Second, the project operator would have to certify annually to the Treasury Department that the project is in compliance with the targeting requirements. Failure to comply with the set-aside requirements would result in loss of tax-exemption for interest on bonds used to finance the project, retroactive to the date of their issuance. In addition, failure to correct noncompliance with the set-aside requirement would result in the nondeductibility of interest on bond financed loans. Failure to make the required annual certification would result in a penalty of $100 per failure.

Finally, the House bill would subject multifamily IDBs to a single, unified volume cap, along with all other so-called "non-essential function bonds." As noted above, multifamily IDBs are not subject to any volume restriction under present law. The House bill's volume limitation is discussed above in connnection with mortgage revenue bonds.

NAHB does not quarrel with the stricter targeting (set-aside) requirements that would be imposed by the House bill. In fact, when we testified last summer before the Subcommittee on Oversight of the House Ways and Means Committee, we suggested the possibility of stricter targeting, provided that such stricter targeting would not destroy the economic viability of the multifamily IDB program. We do not think that the targeting in the House bill is so strict as to do so. Furthermore, we would urge the Senate to adopt the provision of the House bill that provides that a qualified low- or moderate-income tenant is treated as continuing to be such notwithstanding de minimis increases in his or her income. Under that provision, if a family qualified as having low- or moderate-income when initially occupying a housing unit, that family will be treated as continuing to have such an income as long as its family income does not increase by more than 20%. In addition, we would ask the Senate to look favorably upon the House Ways and Means Committee Report language providing that tenants need not be evicted to return a project to compliance.

However, with regard to the family size adjustment requirement of the House bill, NAHB recommends the following:

o Consideration should be given to an adjustment system based on other than section 8 income adjustment factors, because those factors are not geared specifically to IDB-financed projects. The direct subsidy provided in the section 8 program enables incomes, adjusted for family size, to support higher rents than would be affordable if rents were based only on the incomes of the renters. If an adjustment system based on section 8 affordability standards is applied to IDB-financed projects, the resulting income limits may result in rent levels that, in many cases, would be too low to support new construction. The application of section 8 adjustment factors would be particularly problematic in low-income areas.

o The family size adjustment system should be tied to rental unit sizes so that rents could be determined in advanced for purposes of project planning and underwriting.

o A family of three, rather than a family of four, is the appropriate base for family size adjustments. Since 1965, the average family size has declined steadily and stood at 3.23 in March 1985.

o The separate, not combined, income of individuals sharing housing expenses should be considered when qualifying renters for set-aside units.

o Any system of family size adjustment should be tied to current income targeting restrictions for residential rental IDBs.

With regard to the annual certification requirements, we can understand the concern of the House that projects which are financed with multifamily IDBs should meet the set-aside requirements on a continuing basis. However, we are concerned about the added administrative costs this will impose upon project operators. We would suggest that the Senate consider less costly methods of compliance. It may be that periodic certifications on less than an annual basis (perhaps every 3 or 4 years) would accomplish the same results.

A major problem with the House bill is the new annual volume limitation. Multifamily IDBs, which are not now subject to a volume cap, would be lumped into a single, unified volume cap along with most other permissible uses of IDBs. Because of the worthy social goals served by multifamily IDBs, we would urge that they not be subjected to a volume restriction. According to data prepared by the Council of State Housing Agencies, if the volume limitation became effective this year, it would result in about a 21%-45% reduction in multifamily IDBs compared to 1985. If multifamily IDBs are to be limited, we would urge, at a minimum, that the Senate impose a separate cap for them, and that the cap be based on a measure of housing need or construction activity rather than on a per capita basis.

Interest deduction limitations

Under present law, investors in real estate activities generally are not limited as to the amount of interest they may deduct because they are considered to be involved in a trade or business activity. The House bill would sharply restrict the deduction for interest expense attributable to a "limited business interest." A limited business interest would include the following:

o An interest as a shareholder of a subchapter S corporation in whose management the taxpayer does not actively participate;

o An interest as a limited partner in a partnership; and

o An interest in an enterprise as a limited entrepreneur who does not actively participate in the management of the enterprise.

The deduction for interest expense attributable to a limited business interest, along with all consumer debt, would be limited to $10,000 per year ($20,000 on a joint return) plus the amount of a taxpayer's net investment income.

Many multifamily developments are structured in the form of limited partnerships in order to attract the neeeded capital. Without the ability of investors to deduct all interest incurred on debt necessary to finance a development, we are concerned that new construction of multifamily housing will suffer.

In addition, we are concerned that the provision would add further complexity to the Internal Revenue Code, and result in additional administrative disputes. For example, we can envision endless disputes over what amounts to "active participation" in management.

Finally, we are concerned with the potential retroactive impact of this provision, since it would apply to interest paid or incurred after January 1, 1986. Even though the effective date is ameliorated somewhat by a 10-year phase in, it could, in certain situations, apply to individuals who incurred debt well before 1986.

While we can understand the need for some curb on consumer debt, we urge that interest paid or incurred with respect to housing be excepted from any limitation. Furthermore, if the Senate does adopt a limitation, we urge, at a minimum, it except interest with respect to very-low income housing and IDB-financed projects. In addition, if the Senate does impose an interest deduction limitation, we strongly urge that it have no retroactive impact (i.e., it should apply only to debt incurred after a fixed date).

Construction period interest and taxes

Until 1976, construction period interest and taxes were deductible currently. Present law requires construction period interest and taxes for most buildings to be amortized over a 10-year period.

Under the House bill, interest on debt incurred or continued to finance the construction of buildings must be capitalized, if the property is used by the taxpayer in its trade or business or an activity for profit. Thus, construction period interest for most buildings would be added to the cost basis of a building and recovered pro rata over a 30-year period.

Interest expense is a significant component of long-term construction costs. Because of this, the direct impact of the House bill would be to increase the cost of construction. Thus, we would urge that residential buildings be excepted from the capitalization requirements. Furthermore, because of the increased risks associated with low-income housing, we urge that the present law provision allowing current deductibility for construction period interest and taxes related to low-income housing be retained.

Capital gains deductions

As previously noted, NAHB is pleased that the House did not adopt the President's proposal to deny capital gains treatment for buildings. To deny capital gains treatment for buildings would have been a serious detriment to investment in multifamily housing.

The House bill, instead, increased the top capital gains tax rate for individuals from 20 percent to approximately 22 percent. We believe that capital gains should continue to enjoy the same relative advantage as under present law. However, our paramount concern is that buildings continue to qualify for capital gains treatment when sold or exchanged.

Extension of at-risk rules to real estate activities

Under present law, real estate activities are exempt from the at-risk rules which apply to most other types of investments. Thus, investors in real estate limited partnerships are able to deduct losses in excess of actual cash invested, and loans for which they are personally liable, because they are entitled to share in "nonrecourse" liability. The present law at-risk exception makes sense, because lenders to real estate activities generally look only to the value of the property securing the loan in the case of default.

In general, the House bill would extend the at-risk rules to real estate activities. However, qualified nonrecourse financing in a real estate activity would continue to be exempt from the at-risk rules.

Qualified nonrecourse financing would include financing that is secured by real property used in the activity and that is (1) loaned or guaranteed by a Federal, State, or local government, or (2) borrowed by the taxpayer from a "qualified person," provided that such amounts are not used to acquire an interest in property from a related person.

A qualified person generally would be any person who is actively and regularly engaged in the business of lending money. However, a qualified person could not be (1) any person related to the taxpayer; (2) any person from which the taxpayer acquired the property; or (3) any person who receives a fee with respect to the taxpayer's investment in the property.

Essentially, the House bill would limit the at-risk exception to third-party debt from a financial institution. We can understand the purpose of this limitation from the standpoint of the concerns related to potential overvaluation of property for the purpose of "inflating" basis. However, we feel that the limitation in the House bill goes too far in that it would seem to deny the at-risk exception in the case of legitimate joint venture arrangements that do not involve potential overvaluation problems. Thus, we believe the Senate should clarify that joint venture arrangements between taxpayers and "qualified persons" (for example, banks, savings and loan associations, and insurance companies) are within the scope of the "qualified nonrecourse financing" exception. Furthermore, we believe that clarification is needed to provide that certain types of guarantees (*e.g.*, mortgage guarantee insurance) will not cause financing to be treated as other than qualified nonrecourse financing.

IV Other Provisions

There are several other provisions in the House bill that would have an adverse impact upon both single-family housing and multifamily housing. Two of these provisions with which NAHB is particularly concerned deal with the proposed changes to the individual minimum tax, and the treatment of contributions in aid of construction.

Individual minimum tax

The House bill would increase the minimum tax rate from 20 percent to 25 percent. In addition, it would substantially broaden the minimum tax preference base, and revise certain existing tax preferences.

The rationale for the minimum tax is that all individuals and corporations should pay their fair share of tax, without regard to the preferences to which they are entitled for purposes of the regular tax. NAHB does not quarrel with the purpose intended to be served by the minimum tax. In fact, NAHB has existing policy to the effect that all individuals and corporations should pay their fair share of tax. However, we are concerned that the House bill amounts to "overkill" and would drastically undermine the incentive to invest in housing.

The House bill would add two new preferences which we find particularly troublesome insofar as the impact they will have on investment in housing. These are (1) tax-exempt interest on "nonessential function" bonds, and (2) excess passive activity losses.

For purposes of the minimum tax (corporate, as well as individual) tax-exempt interest on nonessential function bonds would be treated as a preference item. Thus, the preference would include interest on tax-exempt mortgage revenue bonds and interest on multifamily IDBs. Because such interest would be a preference item, investors would be much less likely to invest in MRBs and multifamily IDBs. This will raise the interest cost on such issues and have a direct impact on the number of affordably-priced single-family homes and moderate-income multifamily units that are constructed.

Under the House bill, any excess passive activity loss of an individual, to the extent not already denied for minimum tax purposes, would be treated as a preference.

An excess passive activity loss would be an amount equal to the amount by which the aggregated losses for the taxable year from all passive activities exceeds the aggregate income from such activities for the year. This amount would be reduced by certain cash basis of the taxpayer in passive investment activities. However, the amount of cash basis that the taxpayer could take into account with respect to all tax shelters could not exceed $50,000 annually.

An activity would be excluded from treatment as a passive activity if the taxpayer materially participates in the activity or provides substantial personal services for the activity.

We are concerned that the "excess passive activity loss" preference will have a serious adverse impact upon investment in multifamily housing. As noted above, limited partnerships are a common vehicle for investment in multifamily housing. The fact that investors would not be able to utilize, fully, the losses incurred through limited partnership investments would seriously undermine the incentives for investing in multifamily housing. Furthermore, the "cash basis" limitation would seriously undermine the benefit of retaining at least a partial at-risk exception for real estate activities.

We are also concerned with the manner in which the depreciation preference would be computed. Under present law, accelerated depreciation on real property is a preference only to the extent that it exceeds depreciation that would have been allowed under the straight-line method. Under the House bill, depreciation for most buildings would be a preference to the extent that depreciation over a 30-year period under the straight-line method exceeds depreciation over a 40-year period under the straight-line method.

We urge that, as under present law, only the excess of accelerated depreciation over straight-line depreciation should be treated as a preference item.

By raising the minimum tax rate, the House bill greatly reduces the spread between the minimum tax rate (25%) and the top individual income tax rate (38% under the House bill). This, by itself, would be enough to sharply cut back on incentives for investing in housing. If the base for the minimum tax is to be broadened as much as the House bill proposes, we urge that the spread between the minimum tax rate be kept in parity with the spread in those rates under current law (*i.e.*, 20% minimum tax rate versus a 50% top individual income tax rate).

Finally, we are troubled with the retroactive implications of the effective date. The minimum tax would be effective for taxable years beginning after December 31, 1985. This is a particular problem with respect to the proposed new preference for excess passive activity losses. Individuals who took advantage of legitimate tax incentives in prior years could now find themselves subject to the minimum tax. We trust that the Senate will cure this potential inequity.

Contributions in aid of construction

Under present law, contributions in aid of construction received by a public utility company are treated as nontaxable contributions to the capital of the utility. The House bill would treat contributions in aid of construction as taxable income to the utility.

The effect of this provision would be to raise the cost of housing through higher costs for infrastructure development (*e.g.*, water and sewer systems). In fact, we are already aware of situations where utility companies are demanding higher fees from developers in anticipation of the eventuality that they will have to include such fees in their taxable income. Based upon information we have gathered to date, some utility companies are demanding as much as a 60% fee increase.

We urge the Senate to reaffirm the present law treatment of contributions in aid of construction as nontaxable contributions to capital rather than payments made in anticipation of services to be rendered.

V. Economic Impact

Single-family housing

In the case of single-family housing, the reduced personal exemption for taxpayers who itemize deductions, the increase in the standard deduction, the reduction in the deductibility of miscellaneous expenses, and the change in tax rates would all reduce the tax incentive for homeownership. The effect on the after-tax cost of homeownership for a typical middle-income first-time homebuyer would be equivalent to the impact of an increase in mortgage interest rates of about 1.5%. Normally, an increase in mortgage interest rate of that mangitude would reduce single family starts by about 150,000 units. Taking into account the differential effect on mortgage qualification criteria and other mitigating factors, we conservatively estimate that this change would cause a reduction in single family housing starts of about 75,000 units in the first year after enactment. The second year impact would be about equally large. After a few years, pent-up demand and the likely increase in rents will bring the level of single family starts back to the levels that would have occurred under a continuation of current law.

The volume limits on MRBs will have an adverse impact on starts in areas of strong housing demand, contributing another 20,000 units to the first year reduction. The installment sales provision will cost another 15,000 starts. Thus, total reduction in single family starts in the first year after enactment would be about 110,000 units.

Multifamily housing

In the multifamily sector, the adverse impact of H.R.3838 would be relatively much greater. The changes in depreciation, the treatment of construction period interst and taxes, and the changes in tax rates would lower the after tax return to investors in rental housing. In order to provide the same after-tax return to investors, a typical newly constructed apartment renting for $421 under current law would have to rent for $524 under H.R.3838, assuming no change in development costs or interest rates. The additional impact of the limitation on interest expense deductions for non-active partners and the categorization of losses from passive investments as preference items would significantly restrict the flow of capital to rental housing and further raise the rent required to make new construction feasible.

Actual rents are determined by the interaction of demand with the supply of rental housing. Since new construction accounts for only a very small share of total housing supply in the short run, the impact of an increase in the rents required to justify new construction would not be an immediate increase in rents. Instead, the short term result would be a sharp drop in new rental construction and in the resale value of existing properties. The impact on resale values would naturally be reflected in poorer maintenance and accelerated abandonment of existing structures. Over time, the lack of new construction and the deterioration of the existing stock would be reflected in higher rents. After a period of several years, rents would rise to the point where new construction would again be feasible to the same extent as would be true under a continuation of current law.

Even though it may take 5 to 10 years for the increase in required rents to be fully reflected in actual rents, the partial rent adjustments in the first few years will more than offset the savings due to tax reform for most low-and moderate-income renter households. That is because such households devote a much larger share of their incomes to rent than to Federal income taxes.

It is hard to estimate the impact of the changes in the taxation of rental housing on construction activity, because the extent of the changes is so drastic that it is hard to imagine any new development being feasible. However, experience has shown that even under the most adverse circumstances some new construction usually occurs. We expect that the net effect on multifamily housing starts will be a reduction of about 50%, or about a quarter of a million starts, in each of the first two years. The net reduction relative to a continuation of current law would gradually fall as rents rose and vacancy rates became very low, so that by the fifth year, the net difference would disappear.

Another way of looking at the impact of the tax changes is in terms of the equivalent change in interest rates. The impact on returns to equity investors would be similar to an mortgage interest rate increase of 4% to 5%.

For rental properties that, for whatever reason, are financially shaky, a decline in resale values increases the attraction--and therefore the likelihood--of default on the mortgage. Since a non-recourse mortgage loan is effectively an option to sell the property to the lender for the outstanding loan balance, a decline in market resale values may make the lender the involuntary high bidder for distressed properties. Thrift institutions hold roughly half of conventional multifamily mortgages, and many of the most unsound thrift institutions have been among the most aggressive lenders to dubious rental housing investments, so there could be a rather severe impact on the thrift industry and the Federal insurance funds.

VI. Conclusion

The provisions of H.R.3838 that have an effect on housing are of great concern to the membership of NAHB. They will increasingly become a concern of homeowners and renters alike when these impacts become more widely known and understood.

We agree that tax reform may be needed to assure that all taxpayers, both corporations and individuals, pay their fair share of tax. However, we strongly believe that the following principles should guide any major revision of the nation's tax laws:

o First, tax reform should enhance economic growth, savings and investments ... not retard them.

o Second, tax reform should be revenue neutral or revenue positive... certainly not creating a revenue loss which only adds to the Federal deficit.

o Third, tax reform should be fair and not disproportionately affect one industry or group of individuals at the expense of another.

o Fourth, tax reform should not erode the national commitment to homeownership and affordable rental housing.

o Fifth, tax reform should be accomplished in a manner which provides an orderly transition to the new rules. Effective dates should be prospective so that individuals and businesses can plan with certainty.

As the Senate proceeds with the task of rewriting the tax code, we urge you to consider the fact that there has been a major reduction in direct Federal housing spending over the past several years, particularly for low-and moderate-income people and the elderly. This has left the tax code as the cornerstone of national housing policy. The decisions you make on this proposal to a great extent will affect the production of housing, the rents paid for housing, and even the value of housing.

On the question of timing, we urge the Senate to complete serious action on the national deficit problem, before consideration of tax reform.

Finally, we urge the Senate to keep in mind that housing is a significant national interest and an important national priority.

Attachment A

House Bill
Decisions Affecting Housing

Prepared by Government Affairs Division

Single-Family Housing

State and local tax deductions

State and local taxes would remain fully deductible.

Mortgage Revenue Bonds

MRBs for single family housing would be continued through 1987, with the following new restrictions:

- o all bond proceeds must be used to finance homes of first-time homebuyers;
- o the purchase price of MRB-financed homes could not exceed 90 percent (110 percent in targeted areas) of the average area purchase price; and
- o all MRB loans must go to borrowers whose family income does not exceed 115 percent of area median income (with at least 50 percent of loans going to borrowers whose family income does not exceed 90 percent of area median income).

MRBs would be included in a $175 per capita per State volume cap, along with multifamily IDBs and other nongovernmental ("private purpose") bonds.

Second homes

Taxpayers would be permitted to deduct nonbusiness interest on debt secured by up to two residences, without limit.

Homeowner bonds

The proceeds of a loan for which an installment obligation is pledged would be treated as payment on the pledged obligation, and a proportionate amount of deferred gain would be recognized at the time of the pledge. The provision would be phased in over a three-year period. For homeowner bonds issued in 1986, income would be recognized over a three-year period. For bonds issued in 1987, income would be recognized over a two-year period. The provision would be fully effective in 1988.

Energy Conservation Credit

The 15-percent energy conservation credit for residences would expire at the end of 1985.

Solar Energy Credit

The solar energy credit for residences would be extended through 1988 for the first $10,000 of renewable energy property. The credit rate would be 30 percent in 1986 and 20 percent in 1987 and 1988.

Multifamily Housing

At-Risk Rules

Third-party financing for real estate would be exempt from the at-risk rules.

Interest Limitations

The deduction for nonbusiness interest would be limited to the sum of:

- o Interest on debt secured by up to two residences;
- o net investment income; and
- o $10,000 ($20,000 on a joint return).

There would be no interest limitation for investments in very low-income housing or IDB-financed projects.

Depreciation

- o Very low-income housing (40/60 set aside)-20 years/200 percent declining balance.
- o Moderately low-income housing (25/80 or 20/70 set aside, whether or not IDB financed)-30 years/200 percent declining balance.
- o Other buildings-30 years/straight line.

Recapture

Present law (i.e, excess of accelerated depreciation over straight line).

Inflation Adjustment

Basis of depreciable property would be indexed for 50 percent of inflation in excess of 5 percent.

Capital Gains

42 percent exclusion (buildings included). (50 percent exclusion in 1986.)

Multifamily IDBs

Multifamily IDBs would be retained, but with stricter targeting and other new requirements.

Multifamily IDBs could be issued if:

- o 25 percent or more of the units are rented to families whose income is 80% percent or less of area median income, adjusted for family size, or
- o 20 percent or more of the units are rented to families whose income is 70 percent or less of area median income, adjusted for family size.

IDB proceeds would have to be used for rental housing for the longer of 15 years or the maturity date of the bonds with the longest term.

The project operator would be required to certify annually that the project continues to meet the low-income set-aside rules. For purposes of certification, a tenant's income could increase by up to 20 percent.

Multifamily IDBs would be included in a $175 per capita per State volume cap, along with MRBs and other nongovernmental bonds. The cap would drop to $125 per capita in 1988 to reflect the "sunset" of MRBs.

Rehabilitation Tax Credit

The rehabilitation tax credit would be maintained in a modified form. The credit would be 10 percent for buildings constructed before 1936 and 20 percent for historic structures.

Construction Period Interest

The provision allowing 10-year amortization of construction period interest and taxes would be repealed. Thus, construction period interest would be capitalized and recovered through depreciation. Real property taxes would be capitalized under the rules for long-term contracts.

Long-Term Contracts

The completed-contract method of accounting would be repealed for large contractors. Instead, a modified percentage-of-completion method would be required for contracts entered into on or after September 25, 1985. However, contractors with average annual gross receipts of $10 million or less for the three preceding taxable years could continue to use the completed-contract method of accounting for long-term construction contracts lasting less than two years.

Low-Income Housing Rehabilitation Expenditures

Up to $30,000 of expenditures for rehabilitation of a low-income housing unit could be amortized over a 60-month period.

Other Items

Individual Rates

The top rate would be 38 percent. The personal exemption would be $2,000 ($1,500 for itemizers).

Individual Minimum Tax

The minimum tax rate would be increased to 25 percent. New preference items, for purposes of the minimum tax base, would include interest on tax-exempt IDBs and limited partnership losses. Up to $50,000 of losses per year would not be a preference, if the losses reflect cash contributions.

The capital gains rate for the minimum tax would be the same as that for the regular tax.

Charitable contributions of appreciated property would be treated as a preference only to the extent of the taxpayer's other preferences.

Contributions in Aid of Construction

Contributions in aid of construction (*i.e.*, payments by a developer to a utility for infrastructure) would be treated as taxable income.

Corporate Minimum Tax

The minimum tax rate would be increased to 25 percent. Interest on tax-exempt IDBs would be a preference item.

Corporate Tax Rates

The top corporate tax rate would be 36 percent.

Business and Entertainment Expenses

80 percent of business and entertainment expenses would be deductible.

Effective Dates

Most provisions would take effect on January 1, 1986. Certain projects underway as of September 25, 1985, would continue to be governed under present law. Individual rate cuts would take effect on July 1, 1986.

ATTACHMENT B

TAX REFORM PROPOSALS AFFECTING HOUSING

I. SINGLE FAMILY HOUSING

ITEM	PRESENT LAW	PRESIDENT'S PROPOSAL	WAYS AND MEANS COMMITTEE STAFF OPTION	HOUSE BILL
A. State and local tax deduction	Individuals can claim itemized deductions for State and local income taxes, real property taxes, personal property taxes, and sales taxes.	The itemized deduction for State and local taxes would be repealed.	Individuals could deduct State and local income and real property taxes to the extent of the greater of: o $1,000, or o the excess of taxes paid over 5% of the individual's adjusted gross income. Effective date-Tax years beginning after 12/31/85.	State and local taxes remain fully deductible.
B. Second-home interest deduction	No limitation.	Deductions for interest that is not incurred in connection with the taxpayer's principal residence or business would be limited to net investment income plus $5,000.	Deductions for interest that is not incurred in connection with the taxpayer's principal residence or business would be limited to net investment income plus the greater of: o interest on debt secured by the taxpayer's principal residence (to the extent of fair market value), or o $20,000. Effective date: Interest paid in tax years beginning after 12/31/85. There would be a 10-year phase-in.	Taxpayers would be permitted to deduct nonbusiness interest on debt secured by up to two residences, without limit. Effective date-Taxable years beginning after 12/31/85.

ITEM	PRESENT LAW	PRESIDENT'S PROPOSAL	WAYS AND MEANS COMMITTEE STAFF OPTION	HOUSE BILL
C. Mortgage revenue bonds	MRBs must be targeted as follows:	Tax-exemption for MRBs would be repealed.	MRBs would retain tax-exemption, but targeting requirements would be modified:	Same as staff option.
	o at least 90% of proceeds must finance homes of first-time buyers, and o purchase price of homes may not exceed 110% (120% in targeted area) of average area purchase price.	MCCs would be repealed.	o all bond proceeds must be used to finance homes of first-time buyers; o purchase price of homes could not exceed 90% (110% in targeted areas) of the average area purchase price; and o at least 50% of loans must go to borrowers whose family income does not exceed 90% of area median income, and all loans must go to borrowers whose income does not exceed 115% of area median income. (This requirement is liberalized for targeted areas.)	
	Mortgage credit certificates (MCCs) may be issued equal to 20% of each dollar of MRB authority exchanged.		MCCs would be subject to the same targeting requirements.	
	MRBs are subject to a separate, annual volume limit that is equal to the greater of (1) 9% of the average annual aggregate principal amount of mortgages executed during the three preceding years for single-family, owner-occupied residences located within the State, or (2) $200 million.		MRBs would "sunset" in 1987. MRBs would be included in a single, unified State per-capita volume limit. Effective date: Generally, bonds issued after 12/31/85.	

ITEM	PRESENT LAW	PRESIDENT'S PROPOSAL	WAYS AND MEANS COMMITTEE STAFF OPTION	HOUSE BILL
D. Homeowner bonds	If an installment obligation is pledged as collateral for a loan, gain is recognized only as payments on the loan are received.	If an installment obligation is pledged for a loan, the loan proceeds would be treated as payment on the obligation and a proportionate amount of deferred gain would be recognized. If an installment obligation is pledged as collateral for a homeowner bond, the loan would trigger gain to the extent that the loan proceeds exceed the basis of the obligation.	All pledges would be treated as payment on the installment loan and income would be reconized using the gross profit ratio. Effective date-Obligations pledged after 12/31/85 and any obligation created after 9/25/85 if pledged for debt outstanding after 12/31/85. Any installment obligation created before 9/26/85 and pledged before 1/1/86 is treated as pledged on 1/1/91, if still outstanding on 1/1/91.	Same as staff option. Effective date-If an obligation is pledged in 1986, then the ratable portion of the net proceeds of the obligation would be taken into account ratably over a 3-year period. If the obligation is pledged in 1987, it would be taken into account ratably over a 2-year period. (The 1991 date was removed.) Obligations pledged after 9/25/85 and before 1/1/86 would be treated as pledged in 1986.

II MULTIFAMILY HOUSING

ITEM	PRESENT LAW	PRESIDENT'S PROPOSAL	WAYS AND MEANS COMMITTEE STAFF OPTION	HOUSE BILL
A. Deprec tion	In general, buildings have an 19-year recovery period and may be depreciated under the 175% declining-balance method.	Buildings would be depreciated over a 28-year period, using •a 112% declining-balance method.	Most buildings would be depreciated under the straight-line method over a 30-year period.	Most buildings would be depreciated under the straight-line method over a 30-year period.
		There would be no disdinction between low-income housing and other buildings.	Low-income housing would be depreciated over 18 years, using the 150% declining-balance method.	Very low-income housing (40% of units set aside for families with 60% or less of median area income) would be depreciated over a 20-year period, under the 200% declining balance method.
	Low income-housing has a 15-year recovery period and may be depreciated under the 200% declining balance method.	The basis (cost) of real property would be adjusted upward for inflation.	There would be no basis adjustment.	Moderately low-income housing (housing that meets the IDB targeting requirements, whether or not IDB financed) would be depreciated over a 30 year period, under the 200% declining balance method.
	For residential buildings, gain is recaptured to the extent that accelerated depreciation deductions exceed straight-line depreciation. Recapture for low-income housing is phased out after it has been held for a prescribed period. For commercial property, there is full recapture unless the straight-line method was used.	All gain on sale of a building would be treated as ordinary income.	Gain would be recaptured to the extent of previously allowed depreciation.	A partial inflation adjustment (1/2 of inflation in excess of 5%) would become effective in 1988.
			Effective date-Property placed in service after 12/31/85. A transition rule would "grandfather" property that is constructed or purchased pursuant to a contract that was binding as of 9/25/85	

ITEM	PRESENT LAW	PRESIDENT'S PROPOSAL	WAYS AND MEANS COMMITTEE STAFF OPTION	HOUSE BILL
B. Recapture of excess depreciation deductions.	No provision	Taxpayers with "excess depreciation" would have to include 40% of the excess depreciation in income over a 3-year period.	No provision.	No provision.
C. Capital gains	Individuals can deduct 60% of long-term capital gains. Thus, the top capital gains rate is 20%.	Individuals could deduct 50% of long-term capital gains. Thus, the top capital gains rate would be 17 1/2%. Buildings would not be entitled to capital gains treatment.	The capital gains deduction would be 40% (for a top rate of 21%). Gain on the sale of buildings would be entitled to the capital gains deduction, but all previous depreciation would be recaptured as ordinary income. Effective date-Sales on or after 1/1/86. Recapture would apply to dispositions of property placed in service after 1985.	50% exclusion in 1986. 42% exclusion in 1987 and thereafter (22% top rate). Buildings would be entitled to capital gains treatment. Present law recapture (i.e., excess of accelerated depreciation over straight line) would apply.

	ITEM	PRESENT LAW	PRESIDENT'S PROPOSAL	WAYS AND MEANS COMMITTEE STAFF OPTION	HOUSE BILL
D.	Investment interest limitation	Same as I.B.	Same as I.B.	Same as I.B.	The deduction for nonbusiness interest would be limited to the sum of: (1) interest on debt secured by up to two residences; (2) net investment income; and (3) $10,000 ($20,000 on a joint return). The interest limitation would not apply to investments in very low-income housing or IDB-financed projects. Effective date-Taxable years beginning after 12/31/85.
E.	At-risk rules	Real estate activities are not subject to the at-risk rule.	Real estate activities would be subject to the at-risk rule. Thus, losses could be deducted only to the extent of cash invested plus debt for which there is personal liability.	Same as President's proposal. Effective date-Losses with respect to property acquired after 12/31/85.	The at-risk exception would appl to nonrecourse debt from a thirc party lender.
F.	Rehabilitation tax credit	15 percent for 30-year old buildings. 20 percent for 40-year old buildings. 25 percent for historic structures.	Repealed.	10-percent credit for buildings constructed before 1936. 20-percent credit for historic structures.	Same as staff option.

ITEM	PRESENT LAW	PRESIDENT'S PROPOSAL	WAYS AND MEANS COMMITTEE STAFF OPTION	HOUSE BILL
	For 15 percent and 20 percent credit, depreciable basis is reduced by full credit amount. For 25 percent credit, basis is reduced by 1/2 credit amount.		Full basis adjustment. Effective date-Property placed in service on or after 1/1/86. "Grandfather" for rehabilitation pursuant to binding contracts in effect on 9/25/85.	Same as staff option.
G. 60-month amortization of low-income housing rehabilitation expenditures.	Taxpayers can amortize over a 60-month period certain expenditures for improvement of low-income housing. Eligible expenditures cannot exceed $20,000 (in certain cases $40,000) per unit.	Repealed. Expenditures would be added to depreciable basis.	Retained, with a $30,00 per unit limit. Effective date-Expenditures paid or incurred on or after 1/1/86. $40,000 limit would be "grandfathered" for binding contracts existing on 9/25/85.	Same as staff option. Same as staff option.
H. 10-year amortization of construction period interest and taxes.	Construction period interest generally is capitalized and amortized over a 10-year period.	Construction period interest would be added to depreciable basis.	Same as President's proposal. Effective date-Interest incurred after 12/31/85.	Same as President's proposal.

ITEM	PRESENT LAW	PRESIDENT'S PROPOSAL	WAYS AND MEANS COMMITTEE STAFF OPTION	HOUSE BILL
I. Multifamily IDBs.	Interest earned on IDBs for multifamily housing is tax-exempt. To qualify as multifamily IDB: o at least 20% (15% in targeted area) of housing units must be occupied by persons whose income does not exceed 60% of area median income when they first rent unit; and o must be used for rental housing for 10 years or 50% of term of bonds with longest maturity. There is no volume limitation.	Repealed.	New targeting requirements: o at least 30% (25% in targeted areas) of housing units must be occupied by persons whose income does not exceed 70% of area median income and at least 10% must be occupied by persons whose income does not exceed 50% of median area income (this requirement must be met on a continuing basis); o bonds must be used for rental housing for the longer of 15 years or the maturity date of the bonds with the longest term; and o project operator must make annual certification to Treasury that project is in compliance. All private purpose IDBs would be subject to $175 State per-capita limit (reduced to $100 after 1987). Effective date: Bonds issued after 12/31/85.	Same as staff option, except Multifamily IDBs could be issued if: o 25 percent or more of the units are rented to families whose income is 80% percent or less of area median income, adjusted for family size, or o 20 percent or more of the units are rented to families whose income is 70 percent or less of area median income, adjusted for family size.

III OTHER ITEMS

ITEM	PRESENT LAW	PRESIDENT'S PROPOSAL	WAYS AND MEANS COMMITTEE STAFF OPTION	HOUSE BILL
A. Rate structure	14 brackets, rates varying from 11% to 50%. Zero bracket amount (ZBA) is $3,540 for joint returns. Personal exemption is $1,040.	3 rate brackets: 15%, 25%, and 35%. ZBA increased to $4,000 for joint returns. Personal exemption increased to $2,000.	3 rate brackets: 15%, 25%, and 35%. ZBA converted to standard deduction ($6,000 for joint returns). Personal exemption increased to $1,500. Effective date: 1/1/86	4 rate brackets: 15%, 25%, 35%, and 38%. The personal exemption would be $2,000 ($1,500 for itemizers). The standard deduction would be $4,800 for joint returns. Effective date-7/1/86.
B. Individual Minimum Tax	Individuals with large amounts of tax preference must pay a minimum tax of 20% if this exceeds regular tax liability. There is a $40,000 exemption for joint returns.	Generally the same as present law, but exemptions are lowered ($15,000 for joint returns) and preference base is modified.	Rate increased to 25% and present law exemptions retained. Base broadened to include limited partnership losses and interest from IDBs as preference items. Effective date: Tax years beginning after 12/31/85.	Same as staff option.
C. Corporate Minimum tax	Corporations are subject to add-on minimum tax at 15% rate. Exemption is $10,000 or regular tax liability.	Converts add-on minimum tax to alternative minimum tax (similar to individual minimum tax). 20% rate. $25,000 exemption.	25%-rate alternative minimum tax. $40,000 exemption. Interest from IDBs would be a preference item. Effective date: Tax years beginning after 12/31/85.	Same as staff option.
D. Corporate tax rates	The top corporate tax rate is 46%.	Top rate reduced to 33%.	Top rate reduced to 35%. Effective date: Tax years beginning on or after 1/1/86.	Top rate reduced to 36%. Effective date-Taxable years beginning after 7/1/86.
E. Contributions in aid of conconstruction	Contributions in aid of construction to a public utility are treated as nontaxable contributions to capital.	No provision.	Treats contributions in aid of construction as taxable income. Effective date: 1/1/86	Same as staff option.

The CHAIRMAN. Thank you, gentlemen. We will, of course, put each of your full statements in the record.

Mr. Brenneman.

STATEMENT OF G.V. "MIKE" BRENNEMAN, JR., CHAIRMAN, LEGISLATIVE SUBCOMMITTEE ON TAXATION, NATIONAL ASSOCIATION OF REALTORS

Mr. BRENNEMAN. Thank you, Mr. Chairman. I am Mike Brenneman, chairman, legislative subcommittee on Federal taxation of the National Association of Realtors.

On behalf of the more than 700,000 realtors nationwide, we appreciate the opportunity to express to this committee our concerns regarding the House tax revision bill, H.R. 3838.

Mr. Chairman, the National Association of Realtors believes, along with many Members of the Senate, that the Federal budget deficits should be the No. 1 legislative priority of this Congress, not tax revision. We believe that this view is shared by the overwhelming majority of the American people. We also agree with the many economists who have testified before the Senate Finance Committee, that H.R. 3838 is anti-investment, antigrowth, and could precipitate a major recession in this country.

We are very concerned that the homeownership rate in this country has been on the decline ever since 1980, particularly for low- and moderate-income persons. H.R. 3838 would do nothing to reverse this decline. To the contrary, home ownership costs would go up and so would rents.

Members of this committee are well aware of the importance of maintaining an adequate supply of affordable homes and rental housing. Therefore, you realize the need for Congress to go slowly, if major changes are not in the end going to damage an important sector of the economy, housing and its financing system.

DEDUCTIONS FOR PROPERTY TAXES AND INTEREST PRESERVED

The House wisely took steps to improve the housing provisions in H.R. 3838 over those that existed in earlier tax reform proposals. For example, the House preserved the deduction for local property taxes and for interest expense on first and second homes.

The House bill also rejected proposals to alter depreciation recapture rules. These House improvements must be preserved and the Senate should make additional improvements if an adequate supply of affordable housing is to be maintained.

For homeowners and potential home buyers, this bill still contains pitfalls. For renters, the bill is an even greater disaster. Let me quickly list those areas of greatest concern, beginning with home ownership.

First, mortgage revenue bonds. Without going into great detail there, we echo the comments of Mr. Tetreault, who spoke earlier on behalf of the Association of Local Housing Finance Agencies. It is a very important financing system, especially during times of high interest rates, and the House bill would significantly damage this program by reducing State and local issuing authority; by restricting the program to first-time home buyers, by reducing qualifying home purchase prices, and by requiring that at least 50 percent of all MRB home buyers have incomes no greater than 90 percent of the area median income.

We urge Congress to reject Federal income limits for MRB home buyers and return this issue to individual States for their own determination. Moreover, this program is subject to sunset under current law at the end of 1987. We believe that unless Congress is willing to extend that sunset date, then all the House targeting rules—purchase price reductions or whatever—should be rejected.

H.R. 3838 also contains a provision that would disallow $500 in individual itemized deductions per exemption. This has the effect of reducing the deductibility of mortgages and property taxes, which H.R. 3838 purports to preserve in full. Ironically, the relative impact of this provision on home ownership costs is greater for low- and middle-income homeowners than for upper-income homeowners, because it is an absolute dollar amount reduction as opposed to a percentage reduction.

It is also severely biased against the family, since the amount disallowed increases with the number of family member exemptions. We feel that this entire approach should be eliminated from any tax program.

With respect to rental housing, the costs of which would increase under H.R. 3838, basically due to the bill's treatment of depreciation, the increase in capital gains tax rate, the cap on deductibility of investment interest expense and the unnecessarily complex minimmum tax proposed by the bill.

H.R. 3838 would change the depreciation rule for rental housing structures from 19 years with acceleration to 30 years with no acceleration, except for low-income housing. This is considerably more harsh than the provisions of law which applied prior to 1981—and may I remind you that at that time, real estate investment and the economy were stagnating. This change would be a significant factor in reducing yields on residential housing investments, and reduced yields will inevitably be followed by rent increases and a decrease in rental housing investments leaving an even greater shorter of rental housing than already exists.

The proposed limit on deductibility of investment interest expense would make it difficult for limited partnerships to attract the capital necessary to invest in multifamily property. This provision seems particularly unreasonable in light of the fact that it raises less than $500 million in Federal revenue over 5 years.

Incidentally, lest anyone doubt the significance of limited partnerships in today's real estate arena, a recent survey by the National Association of Realtors indicates that better than 40 percent of recent apartment building transfers have involved limited partnerships as purchasers. A limited partnership has proved to be an extremely effective vehicle for the average wage earner to earn a piece of major real estate developments.

RAISE MAXIMUM CAPITAL GAINS TAX RATE TO 22 PERCENT

H.R. 3838 would raise the maximum capital gains tax rate from 20 to 22 percent, while the maximum tax rate on ordinary income is reduced from 50 to 38 percent. We believe this would discourage risktaking and capital formation and would suggest that the current differential in tax rates between ordinary income and capital gains should be maintained.

Finally, the alternative minimum tax proposed by H.R. 3838 is so broad and contains such a high tax rate that it would actually be a parallel tax rather than an alternative tax. Specifically, we believe the alternative minimum tax rate should be no higher than 20 percent for individuals. The net passive loss provisions should deny the deductibility of losses only if the losses exceed the amount of case invested.

I thought, incidentally, that Senator Long's comment the other day was a very interesting one, that he'd hate to see somebody go broke and have to pay taxes in the process. [Laughter.]

Furthermore, this net passive loss provision should not apply to existing debt.

Again, finally, it is the position of the National Association of Realtors that all provisions of tax reform legislation should be effective no sooner than the first of the year following the date of enactment, and that no provision be retroactive.

Senator Mattingly's earlier comments were right on the target. A January 1, 1986, date, as presently proposed, has not just had chilling effects on real estate investments, it has had a deep freeze on real estate investments.

Senator **Riegle**. You know, let me just stop you there. I agree with you on that point, and I asked someone the other day what the revenue implication was of tossing out the effective date of the first of this year on an annual basis, and I was told—I don't know if this is right—that the dollars were about $30 billion. If anybody wants to challenge that or has another figure, I'd be happy to hear it, but it sounds to me like—well, I support what you're saying, and I want to see us do that—it leaves us a big revenue hole that we're going to have to fill some other way or else cut back on other things that the President has proposed to do in terms of further tax benefits for people, but it's not an insignificant revenue item, apparently. It's a pretty big one.

Mr. **Brenneman**. I wonder, Senator, when that figure was given to you, whether they took into consideration the fact that the chilling effect, which is already in place, is obviously causing a far lesser number of transactions to take place and generating a far lesser number of tax dollars.

Senator **Riegle**. I would think it probably doesn't. That's a very good point. I would think it's probably a static analysis rather than one that really tries to measure what activity is being blocked and stalled.

Mr. **Brenneman**. But those analyses in the past have definitely been of a static nature.

Again, thank you for the opportunity to express to this committee the concerns that the National Association of Realtors has with the housing provisions of H.R. 3838, and I would be pleased to respond to any questions you might have.

[The complete prepared statement follows:]

STATEMENT
ON
BEHALF OF THE
NATIONAL ASSOCIATION OF REALTORS®
BY
G.V. BRENNEMAN, JR.
BEFORE
SENATE COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS
FEBRUARY 6, 1986

I. Introduction 1

II. Homeownership Provisions of H.R. 3838. 2

- A. Mortgage Revenue Bonds (MRBs). 2
- B. $500 Cutback in Individual Itemized Deductions per Exemption . . 4

III. Rental Housing Provisions of H.R. 3838 5

- A. Depreciation 5
- B. Mortgage and "Investment" Interest 6
- C. Alternative Minimum Tax. 7

IV. Effective Dates and Transition Rules 9

- A. REALTORS® Position on Effective Dates. 9
- B. Effective Dates. 9

Additional Provisions of Concern on H.R. 3838. 9

V . Macroeconomic Impacts. 10

I. INTRODUCTION

I am G.V. Brenneman from Chevy Chase, Maryland, the 1986 chairman of the NATIONAL ASSOCIATION OF REALTORS® Legislative Subcommittee on Taxation. On behalf of the more than 710,000 members of the NATIONAL ASSOCIATION OF REALTORS®, we appreciate the opportunity to present our views on the impact that the House-passed tax reform bill, H.R. 3838, would have on homeownership and housing investment.

While tax reform is a revolutionary piece of legislation with the potential for dramatic impact on the economic well-being of our country, we do not believe it is the most significant issue facing our country today. The NATIONAL ASSOCIATION OF REALTORS® believes that the soaring, uncontrolled budget deficits, which are a darkening cloud on this nation's economic horizon, should be the number one legislative priority of Congress. The budgetary issues presented by the Gramm-Rudman-Hollings legislation should be sorted out before Congress approves major tax code restructuring, which economists from all political persuasians agree will, at best, have no impact on economic growth and may, in fact, plunge the U.S. economy into recession (see Table 1). We, therefore, believe that the wise course would be to set aside the current tax revision efforts.

The House bill, H.R. 3838, contains serious pitfalls for this nation's homeowners, homebuyers and renters. Even so, the House did make important improvements over earlier tax reform proposals from the Treasury Department, the President and the Ways and Means Committee Chairman's initial proposal. For example, H.R. 3838 retains the important homeowner deductions for property taxes and mortgage interest. The House also wisely rejected proposals to fundamentally alter the depreciation recapture rules which determine how gain is to be taxed upon property sale. We believe that these important improvements must be maintained and that further improvements should be made by the Senate to ensure a future adequate supply of affordable housing.

II. HOMEOWNERSHIP PROVISIONS OF H.R. 3838

Homeownership is on the decline in America. The most recent figures show that only 63.9% of American households are homeowners--a sharp drop from the peak level reached in 1980. Importantly, all of this homeownership decline has been experienced by individuals below age 40 (see Exhibits 1 and 2). Taken in total, the House bill does nothing to address this problem and in fact makes homeownership more difficult and more costly relative to current law . As Table 2 in the appendix shows, the after-tax cost of a typical home would increase by about 9 to 13 percent or $600 to $1,200. Further analysis shows that single family housing starts would decrease under H.R. 3838 by about 5 to 8 percent per year and that resales of existing homes would also decrease by about 4 to 7 percent per year. Our specific concerns with H.R. 3838 follow.

A. Mortgage Revenue Bonds (MRBs)

H.R. 3838 would require that all tax exempt bonds issued after 1985 to finance non-governmental activities, including single-family owner occupied and rental housing, be subject to a state-by-state annual volume cap of $175 per resident. (Twenty-five dollars per resident of this cap is reserved for Sec. 501(c)(3) groups and one half of the remaining amount is reserved for "housing" bonds.) This would greatly reduce the volume of mortgage revenue bonds (MRBs) that states and localities could issue. Mortgage revenue bonds helped over 500,000 families become homeowners during 1982-1984 and an additional 300,000 in 1985 alone. We estimate that under H.R. 3838, the MRB annual volume nationwide would be cut by about one third to one half -- thus denying this important homeownership financing mechanism to over 100,000 families per year. The homeownership rate in America (63.9 percent) is already at a 15 year low, and slashing the MRB program in this way will only exacerbate this trend.

The volume limitations proposed in H.R. 3838 would reduce the amount of MRBs issuable in 1986 to between $6.3 and $8.3 billion from about $12.5 billion in 1985. In addition, the elimination of the separate volume cap for MRBs would create confusion and uncertainty from year to year regarding the amount of bonds available for single-family homes. We prefer the separate MRB volume cap under current law which provides state housing planners with a degree of certainty in determining how to meet their housing needs.

H.R. 3838 also proposes to:

-- limit the MRB program solely to first time homebuyers;

-- reduce qualifying home prices from 110 percent of average area purchase price (120 percent in targeted areas) to 90 percent of average area price (110 percent targeted); and

-- require 50 percent of all MRB homebuyers to have incomes of no greater than 90 percent of the area median.

These so-called "targeting" provisions would further hamstring the MRB program. For example, the fixing of federal income limits would restrict the pool of homes eligible for MRB purchase at an unreasonably low level. High cost areas would be hit the hardest. In Los Angeles, for example, H.R. 3838 would require 50 percent of the families eligible for MRB financed to have incomes of $25,900 or below. A $26,000 family income would be able to afford a MRB financed home (assuming an interest rate of about 9.5 percent with 5% down) costing approximately $68,000. However, the homes available in the Los Angeles area within this affordability range are less than 10 percent of the total homes on the market. This imbalance between income and home prices would reduce the effectiveness of the MRB program. Reduced effectiveness could result in reluctance on the part of state and local housing agencies to issue bonds because of the risk involved in completing sale of the active issue. Finally, it should be noted that the Mortgage Credit Certificate (MCC) program, which was implemented just last year as an alternate, more efficient financing program, would be subject to these same restrictions on MRBs.

The disruption in the MRB program from H.R. 3838 is particularly unreasonable in light of the fact that the MRB program is scheduled to sunset in 1987 and that the proposed targeting rules would result in no increased revenues to the Federal Treasury. We believe that Congress should extend the sunset date and let the states determine income eligibility limits as they have in the past since the MRB program has functioned effectively under these existing rules. Also, Congress has addressed the MRB targeting issue many times in the 1980's. In 1982 and 1984, many of these same targeting rules were on the table and rejected as unworkable. In fact, Congress increased the purchase price limit and allowed 10% of the MRB proceeds to go to non-first time homebuyers in 1982 because the program was not able to function. Congress, in essence, told individual states that they should set their own income limits and otherwise target the homebuying assistance as each state individually desired. We believe that this policy of allowing individual state determinations should continue.

The NATIONAL ASSOCIATION OF REALTORS® has always supported MRBs as a means of countering high interest rates. The proposed targeting requirements, while unworkable even at today's relatively reasonable interest rates, will have their most detrimental effect when interest rates are high and MRBs are needed most. For example, if mortgage rates rose just 2 to 2.5 percent, the Los Angeles based family mentioned above with the $26,000 income would only be able to afford a home costing approximately $58,000 assuming a MRB adjusted interest rate of 11.5%. Homes available in the Los Angeles area within this affordability range are only 5% of the total homes on the market.

B. $500 Cutback in Individual Itemized Deductions per Exemption

H.R. 3838 would increase the annual after-tax cost of owning the median-priced single family home by about 9 percent or over $600 while the homeowners' federal tax liability would remain unchanged (see Tables 2 and 3). A significant portion of the increase in homeownership costs is due to a provision in the bill which disallows $500 of itemized deductions per exemption claimed. This disallowance is actually a backdoor means of reducing the deductibility of mortgage interest and property taxes which H.R. 3838 purports to preserve in full. Ironically, the relative impact of this provision on homeownership costs is greater for low and middle-income homeowners than for upper-income homeowners because it is an absolute dollar amount reduction as opposed to a percentage reduction. Further, it would make owning a home more expensive for families than for childless couples or singles. We believe this $500 per exemption penalty for itemizers is patently unfair and must be removed from H.R. 3838.

III. RENTAL HOUSING PROVISIONS

The development of an adequate supply of rental housing depends on reasonable incentives to help overcome the tremendous risks involved in the real estate business. Much has been made of "tax sheltering" abuses in real estate investments. While we stand ready to continue to assist Congress and the Treasury Department in stopping abusive tax shelter operations, we do not believe Congress should lose sight of the need for adequate tax incentives in real estate, particularly in furtherance of providing affordable housing. Our analysis is that rents across-the-board would be increased if H.R. 3838 were enacted because investment yeilds would decline significantly. Further, multi-family rental housing starts would be slashed by about 20 percent per year under the House bill.

A. Depreciation

H.R. 3838 would change the depreciation rules for rental housing structures from the current 19 years with acceleration to 30 years straight-line. Accelerated depreciation would only be allowed for low-income rental housing. Thirty year straight-line depreciation is more harsh than the capital recovery rules applicable prior to 1981

-- when investment in new rental housing stagnated, rental vacancy rates declined and rents increased sharply. Prior to 1981, structures may have been depreciated over a 40-year life. However, component depreciation was also in effect allowing the component systems of a structure, such as the plumbing, elevators and elecrical systems, to be depreciated over shorter lives. This reduced the overall depreciable life of structures to between 22 and 28 years on average.

Under a 30 year depreciable life, the present value of depreciation deductions over a 10 year holding period would be about 50 percent lower than under 19 year straight-line. By itself, this represents a potential rent increase of more than 10 percent, about $40 per month, for the typical apartment rented by a family earning less than $15,000. The depreciation change, along with the other real estate provisions in H.R. 3838, would slash yields on residential housing by 20 to 45 percent -- driving investors to other investments, thus further reducing development of already short rental housing, leading to significant rent increases in the future (see Tables 4 and 5).

B. Mortgage and "Investment" Interest

H.R. 3838 preserves the full deduction for mortgage interest expense incurred on the taxpayer's principal residence plus one other residence. (There seems to be a conflict between the committee bill and the committee report, though, as to whether the mortgage interest expense attributable to the time a mixed use second home is vacant will be deductible without limit). However, all other non-trade or business interest expense (including consumer interest and interest expense passed through a limited partnership) would be limited to $10,000 plus net investment income for individuals and $20,000 plus net investment income for couples. This provision raises less than $500 million over 5 years yet would severely discourage investment in rental housing by individuals through limited partnerships.

The decline in yields would cause an immediate drop in values of existing properties and a sharp decline in investment in new properties. This decline in investment in new properties ultimately will lead to significant increases in rents.

For example, on a typical rental housing investment by a limited partnership using 10 percent cash equity, the interest limit would cause a 45 percent decline in yield. This decline would correspond to a 17.5 percent increase in rents. This would mean about a $60 rent increase per month for the typical apartment rented by a family earning less than $15,000 (see Tables 4 and 5).

C. Alternative Minimum Tax

The NATIONAL ASSOCIATION OF REALTORS® believes that an alternative minimum tax (AMT) should be just that -- alternative and minimum. Its purpose should be to ensure that all taxpayers pay a fair share of tax. Its purpose should not be to raise revenue and act as a parallel tax system that undermines the incentives Congress consciously chose to include in the tax code. Nor should a minimum tax sweep a large percentage of taxpayers into it by employing a broad AMT base and a high AMT rate. Such an AMT is a contradiction of the regular income tax and unnecessarily complicates tax planning and filing for many taxpayers. H.R. 3838 proposes such an alternative minimum tax.

Housing investment tax preferences in H.R. 3838's alternative minimum tax provisions (AMT) include: the excess of 30-year, straight-line depreciation over 40-year, straight-line depreciation for property placed in service in 1986 or later; net loss from passive investments (the preference item would not apply to the extent of the lesser of $50,000/ year, or the amount of the taxpayer's net cash contribution to an activity); the amount of capital gain excluded under the regular tax, and interest on newly issued non-governmental obligations that continue to be exempt, such as interest on mortgage revenue bonds or industrial development bonds. H.R. 3838 also raises the AMT rate to 25 percent from 20 percent.

The 25 percent AMT rate is excessively high especially when considered with the broadening of the AMT base and the lowering of the top regular income tax rate to 38 percent. H.R. 3838 would transform the AMT into a parallel tax system that will catch many unwary taxpayers and indirectly discourage investment in assets chosen by Congress to receive various tax incentives. A 20 percent AMT rate would help alleviate this undesirable result.

The AMT is so broad that it would render many of the regular tax investment incentives meaningless. For example, the $20,000 interest expense deductible amount and the exception from the "at-risk" rules are largely negated by the AMT net loss provision. To illustrate, assume an investor in a limited partnership is "at-risk" for his investment. Also assume he has a loss of $20,000, investment interest expense of $40,000, no investment income and a cash basis of $10,000. For regular tax purposes, he may deduct $20,000 in loss and $20,000 of investment interest expense. For AMT purposes, only $10,000 of loss is deductible and no interest expense is deductible. Thus, the regular tax allowances are rendered largely meaningless.

The net loss provision also goes so far as to deny the deduction of real losses (1:1) from passive investments in excess of $50,000. (a seemingly arbitrary and inexplicable figure). For example, a limited partner whose combined cash basis in six different limited partnerships is $60,000, would have to include losses in excess of $50,000 as a preference item. This provision thus taxes the investor on income he has actually lost. If this provision remains in the bill, at the very least, losses up to the amount of cash invested should not be included as a preference item.

The AMT would also undermine capital formation provisions such as depreciation because it considers 30 year straight-line depreciation an incentive and the difference between 30 year incentive depreciation and 40 year non-incentive depreciation a preference item. The NATIONAL ASSOCIATION OF REALTORS® does not consider 30 year straight line depreciation an incentive and thus disagrees with this preference item.

The AMT provisions apply to existing as well as future transactions. This means that an investor who invested in a previous transaction based on an expected return and an expected tax consideration will find his investment expectations distorted. We urge Congress to reject any provisions, such as the passive loss rule, which apply in a retroactive nature.

Rental residential housing needs tax incentives to be workable. If these incentives are removed in either the regular tax or the alternative minimum tax, values will drop resulting in reduced housing investment which will lead to shortages in adequate and affordable housing.

IV. EFFECTIVE DATES AND TRANSITION RULES

A. REALTORS® Position on Effective Dates and Transition Rules

It is the position of the NATIONAL ASSOCIATION OF REALTORS® that all provisions of tax reform legislation should be effective no sooner than the first of the year following the date of enactment and that no provision be retroactive.

B. Effective Dates

The majority of the provisions in H.R. 3838 are scheduled to be effective January 1, 1986. This retroactive effective date has already caused a substantial decline in the sale of real property and produced a chilling effect on many investments. The price of investment real estate cannot be determined unless applicable depreciation treatment is known. This situation also applies with respect to: the minimum tax, capital gains tax rates, and the amortization period for construction period interest and taxes.

Another example is the effect of the January 1, 1986 date on the Mortgage Revenue Bond (MRB) and Industrial Development Bond (IDB) programs. Until tax reform legislation is signed into law, bond counsels cannot approve any bond issuances because of the uncertainty surrounding newly proposed volume limitations and targeting requirements. This "freeze" on bond issuances will delay receipt of MRB financing for upwards of 150,000 first-time homebuyers of MRB benefits this year. The Senate and House of Representatives have each acknowledged this unfair retroactive effective date and passed resolutions stating that the effective date should be January 1, 1987. Senators Packwood and Long have acted on the Senate's resolution by sending a letter to senior House Ways and Means Members inviting them to issue a joint statement calling for a January 1, 1987 effective date for tax reform legislation. The NATIONAL ASSOCIATION OF REALTORS® applauds this effort and urges that it continue until successful.

C. Additional Provisions of Concern in H.R. 3838

In addition to the above-mentioned provisions of H.R. 3838, the NATIONAL ASSOCIATION OF REALTORS® is concerned with the effect which the following provisions will have on investment in housing and real estate:

- the newly proposed volume limitations and targeting requirements for multi-family Industrial Development Bonds (IDBs). As with MRBs, the volume restrictions will severely cutback the use of IDBs for rental housing purposes leading to less availability of rental housing and increased rents on those units already existing or being constructed.;

- the dollar for dollar reduction of the IRA ceiling by an employees contribution to a 401(k) plan and the corresponding limit of deferral to $7,000. The United States savings rate is low especially when compared to many other developed nations. Savings incentives should be continued and enhanced. 401(k) plans are particularly helpful in saving for a home because contributions may be applied as a downpayment on a principal residence;

- the increase in the capital gains rate from 20% to 22%. Under current law 60% of the gain on capital assest is excluded from tax, with the remaining 40% taxed as ordinary income. (However, exluded gain is a tax preference item in the computation of the individual minimum tax). With a maximum marginal personal tax rate of 50%, the maximum capital gains tax rate is 20% whichis 60% lower than the rate on ordinary income.

  Under H.R. 3838 the capital gains exclusion would be reduced to 42%. With a maximum marginal personal rate of 38%, the maximum capital gains tax rate would rise to 22% which is just 42% lower than the maximum rate on ordinary income.

- the extension of the "at-risk" rules to real estate to the extent non-recourse seller financing is involved, particularly with regard to smaller rental housing transactions; many states, including California, do not allow recourse seller financing for small rental housing. Therefore, the exception provided in the House bill for recourse financing does not address these smaller transactions.

- the extension of the amortization period for construction period interest and taxes from ten years to thirty years. Interest is an expense and should be allowed as an expense not an addition to basis.

TABLE 1

Macroeconomic Imports of the Ways and Means Tax Proposal
(percent change from baseline)
unless otherwise noted

	1986	1987	1988	1989	1990	1991
Real GNP	-0.4	-1.3	-2.3	-3.2	-3.7	-4.1
Inflation (Percentage Points)	0	-0.1	-0.1	-0.1	-0.1	-0.1
Employment (Millions of Jobs)	0	0.2	0.2	0	-0.2	-0.5
Mortgage Rate (Percentage Points)	0.0	-0.1	-0.3	-0.5	-0.7	-0.8
Housing Starts (Thousand of Units)	-168	-257	-228	-213	-194-	193
Percent	9.3	14.4	12.8	12.6	11.0	11.0
Single Family	-63	-94	-78	-71	-64	-63
Percent	5.7	8.4	6.9	6.2	5.6	5.5
Multi-Family	-105	-163	-150	142	-130	-130
Percent	15.0	24.2	23.3	22.6	21.0	21.1
Existing Single-Family Home Sales (Thousands of Units)	133	241	209	161	144	136
Percent	3.8	6.8	5.8	4.4	3.9	3.1
Nonresidential Investment						
Equipment	-3.0	-9.4	-16.4	-21.8	-24.7	-25.4
Structures	-1.2	-3.9	-7.0	-10.2	-12.7	-14.7

Source: NATIONAL ASSOCIATION OF REALTORS®

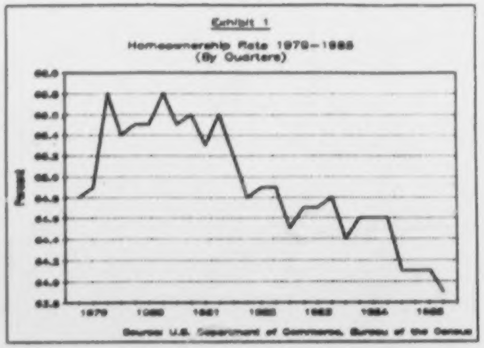

Exhibit 1

Homeownership Rate 1979–1985
(By Quarters)

Source: U.S. Department of Commerce, Bureau of the Census

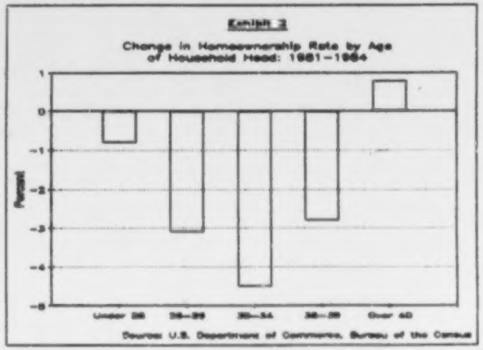

Exhibit 2

Change in Homeownership Rate by Age
of Household Head: 1981–1984

Source: U.S. Department of Commerce, Bureau of the Census

Table 2

Comparison of After-Tax Homeownership Costs Under Current Law and the Ways and Means Proposal[1] (Mortgage Rates Unchanged)

EXAMPLE #1 Cost of Home - $50,000 Required Income - $16,000

	1986 Current Law	Ways and Means Proposal	Change from Current Law $	%
Before-Tax Cost ($)	$5,805	$5,805		
Tax Savings ($)	727	309		
After-Tax Cost ($)	5,078	5,496	+418	+8%

EXAMPLE #2 Cost of Home - $75,000 Required Income - $24,000

	1986 Current Law	Ways and Means Proposal	Change from Current Law $	%
Before-Tax Cost ($)	$8,707	$8,707		
Tax Savings ($)	1,436	812		
After-Tax Cost ($)	7,271	7,895	+624	+9%

EXAMPLE #3 Cost of Home - $100,000 Required Income - $32,000

	1986 Current Law	Ways and Means Proposal	Change from Current Law $	%
Before-Tax Cost ($)	$11,610	$11,610		
Tax Savings ($)	2,427	1,261		
After-Tax Cost ($)	9,183	10,349	+1,166	+13%

EXAMPLE #4 Cost of Home - $150,000 Required Income - $48,000

	1986 Current Law	Ways and Means Proposal	Change from Current Law $	%
Before-Tax Cost ($)	17,415	17,415		
Tax Savings ($)	4,979	4,265		
After-Tax Cost ($)	12,436	13,150	+714	6%

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[1] All examples assume a 20 percent downpayment, a 30-year fixed-rate mortgage with an 11 percent interest rate, and property taxes equal to 1.31 percent of the home value. Required income assumes 28 percent of income is devoted to prinicpal and interest payments. All tax calculations assume a one-earner family filing a joint return with four exemptions.

SOURCE: NATIONAL ASSOCIATION OF REALTORS®

Table 3

Impact of the Ways and Means Proposal on the Federal Tax Liabilities of Homeowners[1]

		Family Income			
		$16,000	$24,000	$32,000	$48,000
(Home Price)		($50,000)	($75,000)	($100,000)	($150,000)
One-Earner Family of Four[2]					
Current Law		$ 386	$ 1,057	$ 1,889	$ 3,786
Ways and Means		283	1,037	1,844	3,279
Change from	$	-103	-20	-45	-507
Current Law:	%	-26.7%	-1.9%	-2.4%	-13.4%
Two-Earner Family of Four[3]					
Current Law		$ 39	$ 715	$ 1,518	$ 3,318
Ways and Means		-33	751	1,559	2,991
Change from	$	-72	+36	+41	-327
Current Law:	%	-184.6%	+5.0%	+2.7%	-9.9%

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[1] Mortgage interest and property tax deductions for families with incomes of $16,000, $24,000, $32,000, and $48,000 are based on homes costing $50,000, $75,000, $100,000, and $150,000, respectively. The mortgage interest deduction is the first year interest on an 80 percent loan-to-value ratio loan with an interest rate of 11 percent. The property tax deduction is 1.31 percent of property value. All non-housing deductions are averages for taxpayers at the respective income levels as reported in the 1983 Statistics of Income--Individual Income Tax Returns.

[2] Child-care credit not used.

[3] Income of family is split two-thirds, one-third between the two earners. Two-earner deduction and child-care credit are used.

SOURCE: NATIONAL ASSOCIATION OF REALTORS®

Table 4

Impact of the Ways and Means
Proposal on Commercial and Rental
Residential Real Estate Investment Yields and Rents

	Relative Decline in Yield[1]	
	10% Equity Ways and Means Proposal	25% Equity Ways and Means Proposal
Commercial[2]		
General Partner or Sole Proprietor	-23.6%	-12.9%
Limited Partner	-35.3%	-17.7%
Residential[3]		
General Partner or Sole Proprietor		
Regular	-36.1%	-20.6%
Regular Low Income	-77.3%	NA
Very Low Income	61.4%	NA
Limited Partner		
Regular	-45.0%	-25.0%
Regular Low Income	-97.9%	NA
Very Low Income	-97.9%	NA

	Increase in Required Rents [4]	
	10% Equity Ways and Means Proposal	25% Equity Ways and Means Proposal
Commercial[3]		
General Partner or Sole Proprietor	+8.3%	+6.0%
Limited Partner	+13.3%	+6.6%
Residential[3]		
General Partner or Sole Proprietor		
Regular	+14.6%	+10.2%
Regular Low Income	+25.8%	NA
Very Low Income	+20.2%	NA
Limited Partner		
Regular	+16.2%	+10.5%
Regular Low Income	+25.0%	NA
Very Low Income	+24.3%	NA

SOURCE: NATIONAL ASSOCIATION OF REALTORS®

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[1] Yield is measured by 10-year after-tax internal rate of return (IRR), which is the discount rate at which the present value of all future after-tax benefits equals the initial equity investment.

[2] For purposes of indexing of capital assets and adjusted basis for inflation a rate of 5 percent is assumed.

[3] Assumptions underlying typical commercial and residential real estate investments:

Basis: $1,000,000 project acquired 1/1/86 with original basis allocated $150,000 to land, $50,000 to furniture, fixtures and equipment, and $800,000 to real property.

Current Law Real Property Depreciation: Commercial-19 years S.L.
Residential-19 years ACRS

Financing: A 30-year conventional mortgage at 13 % interest, evaluated at both 10% and 25% cash down.

Income and Expenses: Net operating income of $100,000 increasing at 5% per year.

Projected Value: Starting Value of $1,000,000 increasing at 5% per year.

Expenses of Sale: Selling expenses of 6% upon ultimate sale.

Ownership: Individual taxpayer(s) in a marginal tax bracket of 50% under current law.

Source: NATIONAL ASSOCIATION OF REALTORS®

Table 5

The Impact of the Individual Provisions of the Ways and Means Proposal Upon Yields and Required Rents

Commercial Real Estate

Separate Alternatives	10% Equity		25% Equity	
	Relative Loss in Yield	Effect on Yield	Relative Loss in Rents	Effect on Values
1) Related-Party At-Risk	-21.9%	+5.6%	--	--
2) Lower Maximum Tax Rate to 30%	-9.6%	+3.4%	-1.6%	+0.8%
3) Lower Capital Gains Exclusion to 42%	-4.8%	+1.8%	-5.9%	+3.4%
4) Investment Interest Rule	-32.9%	+10.4%	-12.4%	+5.9%
5) 30-Yr/Sec 1250 Depreciation	-15.4%	+6.6%	-10.8%	+5.8%

Residential Real Estate

Separate Alternatives	10% Equity		25% Equity	
	Relative Loss in Yield	Effect on Rents	Relative Loss in Yield	Effect on Rents
1) Related-Party At-Risk	-36.1%	+9.6%	-2.0%	+0.8%
2) Lower Maximum Tax Rates to 30%	-14.6%	+5.2%	-4.4%	+1.8%
3) Lower Capital Gains Exclusion to 42%	-3.7%	+1.5%	-5.4%	+3.4%
4) Investment Interest Rule	-45.6%	+17.5%	-19.1%	+9.0%
5) 30-Yr/Sec 1250 Depreciation	-29.2%	+14.4%	-18.6%	+11.0%

OURCE: NATIONAL ASSOCIATION OF REALTORS®

The CHAIRMAN. Thank you, Mr. Brenneman.
Mr. Poe.

STATEMENT OF RONALD F. POE, PRESIDENT, DORMAN & WILSON, INC., WHITE PLAINS, NY, ON BEHALF OF THE MORTGAGE BANKERS ASSOCIATION

Mr. POE. Thank you. Mr. Chairman and members of the committee, my name is Ronald Poe. I am president of Dorman & Wilson, Inc., a mortgage banking company located in White Plains, NY. I am also president of the Mortgage Bankers Association of America [MBA].

MBA appreciates this opportunity to appear before the Committee on Banking, Housing, and Urban Affairs today to testify on H.R. 3838, the Tax Reform Act of 1985, and its impact on housing.

MBA SUPPORTS REDUCTION OF BUDGET DEFICITS

At the outset, let me mention to the committee that MBA strongly supports efforts to reduce the national budget deficit. To this end, we believe it necessary to reduce Federal spending and that no sector of the economy, including defense, should be sacrosanct. In the event that spending reductions are insufficient, then we think that broad-based tax increases may be necessary.

You have specifically asked us to address the provisions of H.R. 3838. Inasmuch as Senate Finance Committee Chairman Bob Packwood has indicated that the Senate Finance Committee will be crafting its own bill and will be considering not only H.R. 3838, but also the President's tax proposals, our testimony will refer to those proposals, where pertinent.

H.R. 3838 has preserved the two most important deductions for homeowners, namely, the deductions for most interest expense and for real property taxes. MBA supports both the full deductibility of mortgage interest expense and the position adopted in the House bill continuing the deductibility of real property taxes. In a study done by MBA and included in my formal testimony, we compared the increases in the after-tax cost of homeownership under H.R. 3838 and under the President's tax proposal in a number of varied metropolitan areas. Because real property taxes are fully deductible under H.R. 3838, the increase in the after-tax cost of homeownership was less under H.R. 3838 than under the President's tax proposals.

If the Senate were to repeal the full deductibility of real property taxes, the impact on the homeowner would be similar to the one under the President's proposals. In some cases, the increase in the after-tax cost of homeownership would be double the increase under H.R. 3838.

MBA is concerned about the number of additional provisions in the House bills that affect investment in income-producing and investment property. MBA believes that subjecting a limited partner's share of a partnership's interest expense to an interest deduction limitation could diminish the effectiveness and attractiveness of multifamily housing as an investment vehicle, and we oppose any restrictions on deductions for interest on investments in real estate.

MBA believes that the changes made by H.R. 3838 that affect the depreciation of real property are also unwise. The increase in the length of the recovery period, combined with the straight line method for conventionally financed multifamily rental housing would reduce the investor's return on investment, especially in the early years. The time value of money makes the larger depreciation deductions in the early years worth more to an investor than greater gain in later years.

MBA recognizes that any tax reform proposal might result in changes in the depreciation system and urges the Senate to combine accelerated deductions with recovery periods shorter than those in H.R. 3838. Making investment in multifamily rental housing more attractive than is provided in the House bill would certainly help maintain an adequate stock of such housing to meet the needs of American families.

INTEREST ON LOW-INCOME HOUSING

MBA is pleased that the House bill would continue the tax exemption for interest on State and local obligations where the proceeds are targeted for housing for the low income, the elderly, and the handicapped. However, MBA opposes the imposition of the State volume cap on tax-exempt bonds used for multifamily rental housing. This restriction would diminish the important role that this financing tool plays in fostering multifamily housing production for the targeted group. Not only would the cap mean that needed low-income housing would not be built, but it would pit the participants in the tax-exempt arena against one another for the limited allocation.

The 25-percent alternative minimum tax in H.R. 3838 nullifies many of the investment incentives for multifamily rental housing. The inclusion of the tax-exempt interest on low-income rental housing bonds as a preference item, as well as the minimum tax treatment of depreciation deductions only aggravates an already adversely affected situation. To limit losses allowable against the minimum tax to an amount less than cash invested by the taxpayer is wholly inequitable.

On a personal note, let me comment on the effective date. I have dedicated my entire professional life to working with cash-flows and attempting to define some certainty for both debt service coverage and for real estate values. To suddenly be faced with a situation where cash-flows, at least on an after-tax basis are uncertain, based on the uncertain date, makes it almost impossible to finance any type of investment property whatsoever.

MBA appreciates this opportunity to testify, and I'd be happy to answer any questions you might have.

Thank you.

[The complete prepared statement follows:]

1125 Fifteenth Street, N.W.
Washington, D.C. 20005
202-861-6500

Mortgage Bankers Association of America

TESTIMONY OF

RONALD F. POE

PRESIDENT
DORMAN & WILSON, INC.
WHITE PLAINS, NEW YORK

on behalf
of the

MORTGAGE BANKERS ASSOCIATION OF AMERICA

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

Hearings on

HR 3838, the "Tax Reform Act of 1985"

February 6, 1986

Mr. Chairman and members of the Committee, my name is Ronald F. Poe. I am President of Dorman & Wilson, Inc., a mortgage banking company, which is located in White Plains, New York. I am also President of the Mortgage Bankers Association of America.*

MBA appreciates this opportunity to appear before the Committee on Banking, Housing and Urban Affairs today to testify on HR 3838, the "Tax Reform Act of 1985," and its impact on housing. Accompanying me are Burton C. Wood, MBA's Legislative Counsel, and Linda K. Bumbalo, MBA's Associate Legislative Counsel.

MBA supports the overall thrust towards simplicity and fairness in the tax laws affecting the American people. MBA looks forward to working with the Administration and Congress on tax reform, especially on issues crucial to housing and real estate finance.

The President has said our tax system should reflect American values and should encourage investment and risk taking. These are the bulwarks of our economic system—our growth, innovation, and entrepreneurship. Homeownership and investment in real estate have long been regarded as integral parts of our national economic and social priorities, and our tax system has reflected these goals. Investment and risk taking are of great concern to Americans, especially at a time when our long-term economic growth rate appears to have slowed relative to earlier in the postwar period. Investing in real estate carries potential risk. Values rise and fall with business cycles. MBA believes that some of the provisions of the tax bill passed by the House of Representatives, HR 3838, the "Tax Reform Act of 1985," could adversely affect the housing industry by reducing the incentives to invest in rental housing and commercial real estate, and could lead to higher rents and lower property values.

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*The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of housing and other real estate finance. MBA's membership comprises mortgage originators, mortgage investors, and a wide variety of mortgage industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, selling, and servicing real estate investment portfolios. Members of MBA include:

- Mortgage Banking Companies
- Commercial Banks
- Mutual Savings Banks
- Savings and Loan Associations
- Mortgage Insurance Companies
- Life Insurance Companies
- Mortgage Brokers
- Title Companies
- State Housing Agencies
- Investment Bankers
- Real Estate Investment Trusts

MBA headquarters is located at 1125 15th Street, N.W., Washington, D.C. 20005; telephone: (202) 861-6500.

MBA has identified the following provisions of HR 3838 as those most relevant to the housing and real estate finance industry and as those that would affect homeownership and investment in rental and commercial property. These are:

Single-family homeownership

- Full deductibility of mortgage interest expense on a principal residence and a second home. MBA supports the full deductibility of all mortgage interest expense.

- Preservation of the full deduction for real property taxes. MBA supports this.

Multifamily rental housing

- A limitation on the deduction of nonbusiness interest expense to $10,000 ($20,000 joint), including passive investment interest, plus net investment income. MBA opposes any limitations on interest on investments in real estate.

- A lengthening of the depreciation period for real property to 30 years, using the straight line method. MBA supports consistency and certainty for capital cost recovery because real estate investment decisions require long-term planning.

- An increase in the capital gains tax rate for real property subject to depreciation. MBA supports appropriate capital gains treatment.

- An extension of at-risk rules to certain real estate activities. MBA supports the continued exclusion of real property from the at-risk rules.

- A state volume limitation on tax-exempt obligations of state or local governments where the proceeds are targeted to meet the housing needs of the low-income, the elderly, and the handicapped. MBA opposes this limitation because needed housing would not be built.

- Amortization of rehabilitation expenses for low-income housing. MBA supports this incentive.

- A reduction of the tax credit for qualified expenditures incurred in connection with the rehabilitation of certain old or historic buildings. MBA supports Federal tax incentives encouraging the rehabilitation of historically designated income-producing properties.

- Retroactivity, as well as the mismatch, of effective dates. The uncertainty and unfairness resulting from this should be corrected.

- An alternative minimum tax. MBA is concerned about its impact on real estate investment.

HOMEOWNERSHIP AS A NATIONAL PRIORITY

Homeownership has been the American dream as long as there has been an America. Throughout the history of our country, homeownership has been a national priority. The first European settlers established their homes on the coast of the new continent, and when the newly formed Nation pushed westward, the government promoted individual ownership of private property by homesteading acts. When our country underwent urbanization and waves of immigrants landed on our shores, the hallmark of individual achievement and success as an American was the purchase of one's own home. For the last 50 years, as has been apparent in our housing programs and in our tax code, it has been an economic and social goal of our Federal government actively to foster the growth of homeownership. Decent and affordable housing for all Americans is one of the basic tenets of our democratic society.

Current Tax Law

From its inception, the tax code has recognized the importance of homeownership as a priority in the American value system. It has been tax policy to make homeownership more affordable for as broad a spectrum of Americans as possible. Purchasing a home is the biggest expenditure most Americans will ever make, and the annual cost of owning a home is a large part of their budget. Because the costs of both purchasing and owning a home are very sensitive to our tax laws, the Internal Revenue Code has always contained provisions which act as incentives for Americans to purchase their own homes.

Since the beginning of the Federal income tax laws, the deductibility of home mortgage interest has enabled many Americans to buy and own homes. In addition, tax law allows Americans to deduct state and local real property taxes from their adjusted gross income. These deductions make homeownership more affordable by reducing the effective cost of owning a home. Thus, by reducing the after-tax cost of homeownership, the tax code has enhanced the ability of Americans to afford their own homes.

MBA has compared the 1986 after-tax cost of homeownership for three income groups under current law, the President's tax proposals, and HR 3838. (Exhibit 1.) For families currently in the 18 percent marginal tax bracket ($20,000 taxable income), the after-tax cost of homeownership would increase 8 percent under the President's proposals and 5 percent under HR 3838. For families currently in the 25 percent marginal tax bracket ($30,000 taxable income), the after-tax cost of homeownership would increase 14 percent under the President's proposal and would remain the same under HR 3838. For families currently in the 33 percent marginal tax bracket ($40,000 taxable income), the after-tax cost of homeownership would increase 13 percent under the President's proposal and 9 percent under HR 3838. MBA believes keeping the after-tax cost of homeownership as low as possible is consistent with long-standing tax policy.

HR 3838, THE "TAX REFORM ACT OF 1985"

Tax reform has been fostered by the general impression that the current tax code is unfair, overly complex, and a hindrance to economic growth. HR 3838, like the President's tax proposals, focuses on the lowering of marginal tax rates for individuals. In order to do this without losing revenue, the amount of income subject to taxation is increased by the elimination or restriction of deductions, credits, and preferences, some of which affect housing. The impact of these changes will cause Americans to reevaluate their investment decisions.

Limitation on the Deductibility of Interest

Under current law, there is a limitation on the deductibility of investment interest expense; but nonbusiness interest expense, including mortgage interest expense, is not subject to limitation. In general, under HR 3838, the deduction for all nonbusiness interest expense would be limited to the sum of $10,000 ($20,000 joint) plus net investment income plus mortgage interest expense on two residences. The President's tax proposals would have limited the nonbusiness interest deduction to $5,000, plus net investment income plus mortgage interest expense on a taxpayer's principal residence.

HR 3838 recognizes that encouraging homeownership is an important policy goal, achieved in part by providing a deduction for residential mortgage interest. Therefore, the limitation on interest in HR 3838 does not affect the deductibility of interest on debt secured by the taxpayer's principal residence or a second home.

MBA believes the deductibility of mortgage interest expense on residences is consistent with this Nation's long-standing commitment to homeownership opportunities for all American families and opposes any restrictions on the deductibility of home mortgage interest. For the first time in the history of the Internal Revenue Code, mortgage interest expense would be subject to limitation. MBA supports the full deductibility of mortgage interest expense.

MBA is especially concerned about the provision in HR 3838 that subjects a limited partner's share of the limited partnership's interest expense to the nonbusiness interest limitation. Multifamily residential projects financed by limited partnerships could be sharply curtailed as their attractiveness as an investment vehicle would diminish. MBA opposes any restrictions on the deductions for interest on investments in real estate.

The Deductibility of Real Property Taxes

HR 3838 would preserve the full deductibility of real property taxes by homeowners. The President's tax proposals would repeal this deductibility. MBA supports the position adopted by the House of Representatives. Any restraint on this deduction would directly impact the American homeowner by increasing the after-tax cost of homeownership and adversely affecting the relative price of housing. MBA urges the Senate not to lose sight of the important social purpose of adequate housing currently fostered by the present tax code. To leave intact the full deductibility of real property taxes is an acknowledgement of the significant role it plays in making homeownership more affordable to more Americans.

MBA has analyzed the impact of the provisions of both HR 3838 and the President's tax proposals on the first-year after-tax cost of homeownership by family income in 16 metropolitan areas. Under HR 3838, which would allow the full deductibility of real property taxes, the increases in the first-year after-tax cost of homeownership for families with incomes of $25,000 range from 4 percent to 7 percent. The increases for families with incomes of $50,000 are 9 percent in 15 metropolitan areas and 10 percent in one. (Exhibit 2.)

Under the President's tax proposal, which repeals the deductibility of real property taxes, the increases in the after-tax cost of homeownership for both family income groups in all 16 metropolitan areas are greater than under HR 3838. The increases for the $25,000 family income group range from 6 percent to 15 percent. In some areas, such as Philadelphia, Houston, Milwaukee, and Detroit, the increase in the after-tax cost of homeownership is doubled under the President's tax proposal, while in a number of other areas the increase is almost doubled. For families with incomes of $50,000, the increases under the President's tax proposals range from 10 percent to 17 percent. (Exhibit 3.)

MBA would like to point out that if the Senate repeals the deductibility of real property taxes, the impact on the homeowner would be similar to the increase in the after-tax cost of homeownership under the President's tax proposals.

MBA opposes any limitation on the deductibility of real property taxes. Any increase in the after-tax cost of homeownership would require American households, especially those with low and moderate incomes, to spend a larger share of their incomes for housing or to reduce the quality of their housing accommodations.

Depreciation Period for Real Property

HR 3838 replaces the current Accelerated Cost Recovery System (ACRS) with the Incentive Depreciation System (IDS), which groups assets into 10 classes. Most real property would be in Class 10 and be depreciated over 30 years using the straight line method. Beginning in 1988, the depreciation deduction would be increased when inflation exceeds 5 percent. In that event, the adjustment is one-half of the inflation rate in excess of 5 percent.

MBA believes that this change, one of a series of disruptive changes over the past several years in the length of the depreciation period for real property, is unwise. Numerous changes in depreciation periods enacted since 1981 have created long-term planning uncertainties.

Prior to 1981, depreciation deductions were allocated over the useful life of the property. The Economic Recovery Tax Act of 1981 eliminated this approach and replaced it with the Accelerated Cost Recovery System (ACRS), under which the cost of assets is recovered over predetermined recovery periods. The recovery period for real property from 1981 to 1984 was 15 years. The Deficit Reduction Act of 1984 increased the minimum real property recovery period to 18 years for property placed in service after March 15, 1984. On October 11, 1985, President Reagan signed P.L. 99-121, amending the tax code sections dealing with imputed interest and lengthening the recovery period again—effective May 9, 1985—from 18 years to 19 years. If HR 3838 is passed, recovery periods would again be lengthened, this time to 30 years.

MBA supports consistency and certainty in the tax treatment of capital cost recovery for real estate. In order to continue to attract investment capital, the recovery period should be a certain term of years and should remain stable over time. Real estate investment decisions require long-term planning and are enhanced by the ability to make long-term projections. The frequent changes for cost recovery in recent years from useful life to 15 years to 18 years to 19 years and then the change to perhaps 30 years, as proposed by HR 3838, hampers the ability of lenders and investors to make sound and reliable long-term plans.

Furthermore, MBA believes that the indexing provision to adjust depreciation deductions only partially for inflation will not adequately compensate investors for the loss in cash flow associated with the substantially longer write-off period.

Multifamily projects would be hit especially hard. Multifamily rental housing would be subject not only to an increase of more than 50 percent in the length of the recovery period, but also to a change from the accelerated method to the straight line method. The effect of these changes is to reduce an investor's return on investment, especially in the early years. Even if gain on disposition is greater under HR 3838, the time value of money makes the larger depreciation deductions in the early years worth more to an investor than greater gains in later years.

This would diminish the attractiveness of multifamily rental housing as an investment vehicle, with the effect of reducing construction. The reduced supply of such housing would mean that rents would rise. This effect on the renting taxpayer could possibly offset any benefits the taxpayer receives because of other provisions in HR 3838.

While MBA believes constant tinkering with the cost recovery system has a deleterious effect on investment in housing, it also recognizes that any tax reform proposal might result in changes in the depreciation system. MBA urges the Senate to provide for shorter recovery periods than those in HR 3838, coupled with accelerated deductions. Making investment in multifamily rental housing more attractive than is provided for in HR 3838 would help maintain an adequate stock of such housing to meet the rental needs of American families.

Capital Gains Tax Rate

MBA supports the continuation of appropriate capital gains tax rates for the sale or disposition of real estate. Such treatment attracts investment capital to construction and real estate development, which in turn contributes to a healthy economy.

Under HR 3838, the top effective tax rate for capital gains would increase from 20 percent to 22 percent. MBA believes that increasing the capital gains taxes on investments in multifamily housing could reduce the supply and boost rents.

The Treasury Department recently released the results of a study on the capital gains tax cut in 1978. In its Report to Congress on the Capital Gains Tax Reductions of 1978, dated September 1985, the Treasury Department concludes that the capital gains rate reduction from 49 percent to 28 percent "will over time cause the rate of investment, the capital stock, national income, labor productivity and the overall standard of living to be higher than if the tax treatment of capital gains had remained unchanged."

The Extension of the At-Risk Rule to Real Estate Activities

HR 3838 extends the at-risk rules to holding real property with exceptions for certain arm's-length, third-party nonrecourse financing. MBA opposes the application of the at-risk rules to holding real property.

The at-risk exception in HR 3838 for arm's-length, third-party nonrecourse financing would apply to a large number of financing transactions. However, any further limitation on this exception would have a drastic impact on the ability to raise equity to finance multifamily housing.

Tax-exempt Financing for Multifamily Low-Income Housing

MBA is pleased that HR 3838 would continue the tax exemption for interest on state and local obligations where the proceeds are targeted for housing for the low-income, the elderly, and the handicapped. MBA supports efforts to make adjustments to the qualifying criteria in order better to serve low- and moderate-income households. MBA also is pleased that low-income housing would continue to receive depreciation deductions that act as an incentive to investors. MBA also applauds the exception for low-income housing from the interest deduction limitation and the at-risk rules.

However, MBA opposes the imposition of the state volume cap on tax-exempt bonds used for multifamily rental housing. This restriction would diminish the important role that this financing tool plays in fostering multifamily housing production for the targeted group. Because Federal spending to subsidize this construction has been cut drastically, tax-exempt financing is one of the few remaining vehicles available to promote multifamily housing production. Not only would the cap mean that needed low-income housing would not be built, but it would pit the participants in the tax-exempt arena against one another for the limited allocation.

Providing adequate housing for the low-income, the elderly, and the disadvantaged has long been a social policy of the Federal government. It should be remembered that when the private sector provides tax-exempt financed low-income multifamily housing, it is carrying out a public purpose. Under current law, such bonds are not subject to the state volume cap for this very reason.

Rehabilitation Expenses for Low-Income Housing

MBA supports the changes made by HR 3838 to Section 167(k) of the Internal Revenue Code. The five-year amortization of rehabilitation expenses for low-income rental housing would be made permanent and the aggregate limit on such expenses would be increased from $20,000 to $30,000 per dwelling unit. This five-year amortization has been repeatedly extended since its original enactment in order not to interrupt the rehabilitation of low-income projects. In recognition of the desirability of retaining this incentive, HR 3838 would continue this provision without expiration. Rehabilitated, as well as newly constructed, rental housing for the low-income is needed to provide all Americans with decent housing.

Historic Rehabilitation Tax Credit

HR 3838 replaces the current three-tier rehabilitation tax credit with a two-tier credit. The credit for rehabilitation of certified historic structures would be lowered from 25 percent to 20 percent, and depreciable basis would be fully adjusted for the amount of the credit. The historic rehabilitation credit would apply to both residential and nonresidential buildings.

MBA supports Federal tax incentives aimed at encouraging the rehabilitation of historically designated income property. The rehabilitation and preservation of historic structures are an important national goal.

Construction Period Interest

HR 3838 effectively lengthens the recovery period for interest associated with the construction of real property from 10 years to 30 years. Under current law, interest is amortized over 10 years. HR 3838 would change its character to a capital expense, include it in basis, and depreciate it over 30 years. In the case of low-income housing, interest would be changed from a current deduction to a capital expense, thereby lengthening the period of its deductibility from one to 30 years.

MBA believes the effect of this change would be increased rents in order to offset the loss of the deduction in the early years. MBA supports current law affecting the treatment of construction period interest.

Alternative Minimum Tax

While HR 3838 provides a number of incentives for investment in rental housing that were not in the President's tax proposals, their effect is in large part nullified by the imposition of a 25 percent alternative minimum tax on a number of deductions designated as preference items.

Tax exemption for interest on low-income multifamily housing bonds is continued for regular income tax purposes, but this benefit is greatly reduced by its inclusion as a preference item at the 25 percent minimum tax rate.

The bill includes as a preference item losses from limited partnerships that are more than the taxpayer's cash basis. In the case of a registered tax shelter, as provided for in the 1984 tax act, the amount of cash basis that the taxpayer can take into account in one year is limited to $50,000, even though the cash basis exceeds that amount. Losses otherwise deductible would be subject to the 25 percent minimum tax.

Incentive depreciation on real property placed in service after 1985, to the extent it is in excess of nonincentive depreciation, is treated as a preference. Nonincentive depreciation for real property other than low-income housing is 40 years, straight-line. This minimum tax on depreciation for real estate only aggravates an already adversely affected situation.

Effective Dates

MBA is deeply concerned about the effective dates in HR 3838. A number of provisions affecting housing would become effective January 1, 1986, if no changes are made. However, because some of these provisions may be changed by the Senate Finance Committee, the housing industry currently is in the position of having to guess what the consequences will be for decisions that require long-term planning.

The price of multifamily rental housing cannot be determined without knowing what depreciation treatment will apply and what the amortization period will be for construction period interest. Other provisions that would be retroactive are the at-risk limitation on losses, new restrictions on tax-exempt bonds for low-income housing, the first-year phase-in of interest deductions limitations, and a stiffer alternative minimum tax.

One of the goals of the tax revision effort is to promote economic growth, not deter it. Which combination of incentives for capital formation is most effective is the subject of much discussion and dissension. Meanwhile, a pall of uncertainty hangs over the housing industry, delaying and deterring market activity and slowing growth.

MBA is also concerned about the mismatch of effective dates. Taxing a larger tax base at current rates for half of a year cuts in half the potential tax benefit associated with lower marginal tax rates.

Effect on Capital Values

Capital values will likely suffer under the new depreciation system and higher capital gains rates. If property values are adversely affected, the principal amount of existing mortgages could exceed the values of the underlying properties. When mortgage loan-to-value ratios are high, the risk of default increases. The investor's equity in the properties will have disappeared and along with it the incentive to keep investing more money in those properties. This is especially true in periods of low inflation when property values have little or no expectation of appreciation and investors see scant prospect for returns on investment.

CONCLUSION

HR 3838, the "Tax Reform Act of 1985," eliminates or restricts tax deductions, credits, and preferences in order to lower individual tax rates on the grounds that the tax system will be fairer. It may also be thought that individuals will save a larger share of their incomes and provide more funds for investment. Yet the evidence from the 1981 tax cut provides little support for the view that lower marginal tax rates increase the rate of personal saving. MBA believes that reducing the Federal deficit is the path to increased national saving, lower interest rates, and faster economic growth. The Federal government is competing with the private sector in the capital market for investment dollars. If those dollars were invested in the private sector rather than loaned to the Federal government, we would have the economic growth the President wants and the Nation needs.

MBA urges caution in any change of the tax provisions affecting both single-family and multifamily housing. America prides itself on being one of the best-housed nations on Earth. We have achieved this stature in large measure by the high priority placed on housing by the Federal government. MBA urges Congress not to lose sight of the important social purpose of adequate housing and the variety of provisions embodied in the present tax code, which are still needed to assure a decent home for all Americans.

MBA appreciates this opportunity to appear and testify. We would be happy to furnish additional information if needed.

EXHIBIT 1

COMPARISON OF FIRST-YEAR AFTER-TAX HOMEOWNERSHIP COSTS UNDER CURRENT LAW, PRESIDENT'S TAX PROPOSAL, AND HR 3838*

	1986 Current Law	President's Tax Proposal	HR 3838
Example 1—House Price: $65,000; Taxable Income: $20,000			
Before-Tax Cost	$ 9,454	$ 9,454	$ 9,454
Marginal Tax Rate	18%	15%	15%
Tax Savings	$ 1,426	$ 772	$ 1,055
After-Tax Cost	$ 8,028	$ 8,682	$ 8,399
Increase in Cost (%)	-	8%	5%
Example 2—House Price: $85,000; Taxable Income: $30,000			
Before-Tax Cost	$12,361	$12,361	$12,361
Marginal Tax Rate	25%	15%	25%
Tax Savings	$ 2,589	$ 1,174	$ 2,589
After-Tax Cost	$ 9,772	$11,187	$ 9,772
Increase in Cost (%)	-	14%	0%
Example 3—House Price: $150,000; Taxable Income: $40,000			
Before-Tax Cost	$21,815	$21,815	$21,815
Marginal Tax Rate	33%	25%	25%
Tax Savings	$ 6,031	$ 4,032	$ 4,569
After-Tax Cost	$15,784	$17,783	$17,246
Increase in Cost (%)	-	13%	9%

*All examples assume a 12 percent, 30-year fixed-rate mortgage with a 10 percent downpayment; property taxes are 1.43 percent of the house value. House prices for each income category are derived from U.S. Census data. Before-tax housing costs are the sum of mortgage payments, property taxes, and an estimate of maintenance, utility, and insurance costs. All tax calculations are based on a married couple filing jointly, and on the average itemizations claimed by taxpayers in the different income categories derived from the Internal Revenue Service publication Statistics of Income.

Prepared by MBA Economics Department
January 31, 1986

EXHIBIT 2

IMPACT OF THE WAYS AND MEANS COMMITTEE PROPOSAL (HR 3838) ON FIRST-YEAR AFTER-TAX COST OF HOMEOWNERSHIP, BY FAMILY INCOME, FOR A MARRIED COUPLE FILING JOINTLY*, IN SELECTED METROPOLITAN AREAS

	$25,000 Family Income			$50,000 Family Income		
Metropolitan Area/State	Current Law After-Tax Cost	After-Tax Cost Under HR 3838	Percent Change	Current Law After-Tax Cost	After-Tax Cost Under HR 3838	Percent Change
Los Angeles, CA	$11,514	$11,983	4	$14,510	$15,834	9
Denver, CO	8,057	8,425	5	9,457	10,320	9
Bridgeport, CT	8,145	8,521	5	8,247	9,015	9
Atlanta, GA	4,366	4,628	6	7,604	8,303	9
Chicago, IL	6,471	6,795	5	6,879	7,516	9
Baltimore, MD	4,446	4,712	6	4,860	5,315	9
Detroit, MI	3,431	3,669	7	3,701	4,056	10
Las Vegas, NV	8,169	8,540	4	8,633	9,417	9
Newark, NJ	5,135	5,422	6	4,600	5,034	9
New York, NY	7,042	7,383	5	7,380	8,062	9
Philadelphia, PA	3,831	4,079	6	4,490	4,908	9
Memphis, TN	5,091	5,375	6	6,730	7,353	9
Houston, TX	6,085	6,399	5	8,750	9,566	9
Salt Lake City, UT	7,120	7,462	5	9,418	10,281	9
Seattle, WA	8,437	8,818	4	9,855	10,757	9
Milwaukee, WI	7,051	7,396	5	7,209	7,891	9

*Assumes 12 percent, 30-year fixed-rate mortgage, 10 percent downpayment; property tax rates and housing prices for each income category and locality are derived from U.S. Census and Advisory Commission on Intergovernmental Relations data. Total housing costs are the sum of mortgage payments, property taxes, and an estimate of maintenance, utility, and insurance costs.

Prepared by MBA Economics Department
January 31, 1986

EXHIBIT 3

IMPACT OF PRESIDENT'S TAX REFORM PROPOSAL ON FIRST-YEAR AFTER-TAX COST OF HOMEOWNERSHIP, BY FAMILY INCOME, FOR A MARRIED COUPLE FILING JOINTLY*, IN SELECTED METROPOLITAN AREAS

	$25,000 Family Income			$50,000 Family Income		
Metropolitan Area/State	Current Law After-Tax Cost	After-Tax Cost Under President's Proposal	Percent Change	Current Law After-Tax Cost	After-Tax Cost Under President's Proposal	Percent Change
Los Angeles, CA	$11,514	$12,223	6	$14,510	$16,073	11
Denver, CO	8,057	8,636	7	9,457	10,476	11
Bridgeport, CT	8,145	8,830	8	8,247	9,344	13
Atlanta, GA	4,366	4,828	11	7,604	8,499	12
Chicago, IL	6,471	7,048	9	6,879	7,745	13
Baltimore, MD	4,446	4,957	11	4,860	5,535	14
Detroit, MI	3,431	3,942	15	3,701	4,332	17
Las Vegas, NV	8,169	8,731	7	8,633	9,516	10
Newark, NJ	5,135	5,712	11	4,600	5,293	15
New York, NY	7,042	7,634	8	7,380	8,282	12
Philadelphia, PA	3,831	4,299	12	4,490	5,086	13
Memphis, TN	5,091	5,606	10	6,730	7,581	13
Houston, TX	6,085	6,669	10	8,750	9,922	13
Salt Lake City, UT	7,120	7,680	8	9,418	10,476	11
Seattle, WA	8,437	9,047	7	9,855	10,954	11
Milwaukee, WI	7,051	7,750	10	7,209	8,315	15

*Assumes 12 percent, 30-year fixed-rate mortgage, 10 percent downpayment; property tax rates and housing prices for each income category and locality are derived from U.S. Census and Advisory Commission on Intergovernmental Relations data. Total housing costs are the sum of mortgage payments, property taxes, and an estimate of maintenance, utility, and insurance costs.

Prepared by MBA Economics Department
January 31, 1986

The CHAIRMAN. Mr. Sherman.

STATEMENT OF ROBERT F. SHERMAN, PRESIDENT, S&S PROPERTIES, INC., DALLAS, TX, AND PRESIDENT, NATIONAL APARTMENT ASSOCIATION

Mr. SHERMAN. Thank you, Mr. Chairman and members of the commmittee. My name is Robert Sherman, I am president of the National Apartment Association. I am also president of S&S Properties in Dallas, TX.

I appreciate the opportunity to present the views of the National Apartment Association regarding the impact of H.R. 3838 on the rental housing industry.

First, I would like to commend you, Mr. Chairman, and this committee, for holding these hearings. The members of the committee are well-versed in housing and understand many of the housing problems facing this country.

I believe the Finance Committee needs your input before they can take any action on a tax reform bill.

I have no doubt that H.R. 3838, as passed by the House, would severely injure our industry. If the bill is enacted into law as it is today, the production of rental housing would decline significantly, rents would increase, property values will decline in the near term and there would be a further deterioration of existing housing stock.

BILL WOULD INCREASE RENTS

Since the Treasury Department's initial proposal was released in November 1984, the National Apartment Association [NAA], has analyzed the various tax reform proposals. Our study of H.R. 3838 concluded that to maintain the current yield for investments in multifamily property, rents would have to increase on average between 16 and 26 percent on properties that are constructed after enactment of the bill into law. In addition, investors, owners, and lenders could experience declines in the value of their holdings of as much as 21 percent, unless rents increase significantly above inflation.

The new production of rental housing would decline sharply in the near term, with a resulting multiplier effect on the national economy.

Any tax savings for rental household families would be quickly absorbed by rent increases, thereby leaving renter households with less money for nonhousing expenditures and forcing the American renting public to bear a disproportionate share of tax reform.

By way of an example, it is estimated that an American couple with an income of $25,000 would save $100 a year in taxes, if the House bill becomes law. Assuming market forces would allow only a 10-percent increase in rent on a $350 per month apartment, the $35 per month increase would be absorbed by the tax savings within 3 months. Clearly, tax reform penalizes the renter household when all the costs and savings are tallied.

At the same time, the tax incentives for homeowners are primarily retained, so that households who can afford to own one or two houses are basically not affected by H.R. 3838. Consequently, it's the National Apartment Association's belief that H.R. 3838 is neither fair nor simple nor profamily for individuals in this country who are renters.

H.R. 3838 would affect the security of debt held by banks and savings and loans. If rents cannot increase to offset the lost tax benefits, the value of the property will decline in the near term. This would affect the loan to value ratio of many of the mortgages. For many S&L's that already have a precarious financial status, a significant decline in values would further jeopardize the stability of the real estate loan portfolios.

FOUR PROVISIONS OF CONCERN WITH H.R. 3838

NAA members are primarily concerned with four provisions of H.R. 3838: depreciation, interest limitations, the effective dates of the legislation, and the alternative minimum tax which would tax partnership losses and housing bonds.

Let me just briefly outline a few of our concerns regarding the proposed change in depreciation.

The lengthening of the depreciation schedule has a significant dollar impact on our industry. The value of the tax incentives of a 19-year accelerated rate is much greater than that of a 30-year straight line rate. In order to compete in the capital markets with other types of investments, particularly commercial property, housing needs a shorter depreciation period at an accelerated rate. This is particularly true in the crucial early years of a building. Residential rental property requires a longer lease-up period than does commercial property. Preleased space is unheard of in rental housing, where it is a necessity in shopping centers and commercial buildings. Therefore, the income stream on rental property tends to be less in the earlier years. An accelerated depreciation schedule offsets the negative cash flow in these early years.

There is a social objective that is served by providing tax incentives to build housing for Americans. NAA supports this goal, and we think that providing housing serves a greater social purpose than providing office space. We urge Congress to maintain some advantage for housing over commercial office space.

Turning to the issue of the interest caps, our members oppose the provision to limit the interest deduction to interest income plus $10,000 for single taxpayers and $20,000 for taxpayers who file jointly. The cap would not apply to interest on mortgages on primary residences or second homes.

The interest caps would treat the interest expense of a limited partner in a limited partnership as investment interest and, therefore, subject to the cap. The real estate industry relies on borrowing a significant portion of the purchase price of the property. If borrowing is restricted and more equity is required, greater rates of return will also be required. This proposed change places further upward pressure on rents, as well as reductions in the value of rental housing.

With regard to the alternative minimum tax, the loss limitation provision in the bill included in the alternative minimum tax would have the effect of taxing actual losses. This provision limits the amount of loss a taxpayer could recognize for purposes of the calculation of the alternative minimum tax. The cap would be the lesser of the cash basis in the investment or $50,000.

If a taxpayer invested $75,000 in a limited partnership and he lost $90,000 that year, he could only deduct $50,000 from his income, to calculate the alternative minimum tax.

Residential property investments typically show large losses in the early years. To limit the losses that could be taken in the early years would diminish the internal rate of return for the investor and consequently, he would seek alternative investments. Hence, residential property would not be built unless the loss of tax benefits are compensated by increased cash flow, which can only be achieved through raising rents.

The alternative minimum tax further restricts the use of tax-exempt housing bonds. H.R. 3838 would subject the interest income from these bonds to the alternative minimum tax, making nonessential purpose bonds taxable under the alternative minimum tax. This would force these bond yields higher in order to compensate for the taxation of interest under the alternative minimum tax. The lower interest costs achievable with tax-exempt bonds benefit the housing industry. Taxation of the interest on these bonds will increase financing costs of housing which, in turn, will increase the rental rates.

Finally, I'd like to address the problem of effective dates. As has been stated before, the effective dates under H.R. 3838 would be January 1, 1986. Today the industry must guess: Will there be tax reform? Will the Senate change either the effective dates or several of the provisions in the bill? Will a House-Senate conference committee change the provisions further? Because the changes that H.R. 3838 proposes are so drastic, the uncertainty that has been created here has frozen the market.

American business is entitled to some degree of certainty so that it does not burn while Washington fiddles. Tax legislation of this magnitude should be prospective rather than retroactive.

Thank you for the opportunity to present the views of the National Apartment Association.

I will be glad to answer any questions that you have.

[Complete prepared statement follows:]

NAA
NATIONAL
APARTMENT
ASSOCIATION

1101 FOURTEENTH STREET, N.W. SUITE 804 WASHINGTON, DC 20005 • 202/842-4050

TESTIMONY

of

ROBERT F. SHERMAN

on behalf of the

NATIONAL APARTMENT ASSOCIATION

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

U. S. SENATE

on

THE IMPACT OF THE TAX REFORM PROPOSAL ON THE RENTAL HOUSING INDUSTRY

February 6, 1986

SUMMARY OF THE TESTIMONY OF ROBERT F. SHERMAN
on behalf of the
NATIONAL APARTMENT ASSOCIATION
before the
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
February 6, 1986

- H.R. 3838, the Tax Reform Act of 1985, will cause the production of rental housing to decline, drive up rents, cause further deterioration of existing housing stock and force the private sector out of the rental housing market.

- NAA commissioned an economic analysis of H.R. 3838 in order to assess the impact of the proposed changes in the tax code on the rental housing industry.

- The following provisions were analyzed: the lengthening of depreciation schedules; the application of the at risk rules to real estate; the limitation of deduction of interest expense; the repeal of the 10-year amortization of construction period interest and taxes and the change in marginal tax rates. If H.R. 3838 becomes law, the following would result:

(1) Rents would have to increase 26 percent in order to offset the proposed tax changes. For the average renter, rents will go up from $350 to over $440 per month, while the tax savings would be in the range of $7 to $15 per month or $84 to $180 per year.

(2) Investor/owners could experience declines in the value of their holdings by more than 21 percent unless rents increase significantly above inflation.

(3) In those developments where higher rents cannot be charged, the construction or rehabilitation of multifamily housing will not take place. The resulting housing shortage will drive rents up. Private industry will not be able to produce decent affordable rental housing, particularly for those income brackets that need it.

(4) The lowering of tax brackets and the expected lower tax for rental household families would be quickly absorbed by rent increases, thereby leaving renter households with less money for non-housing expenditures.

(5) The decline in rental real estate values could have a significant negative effect on loan to value ratios. This would increase the risk to the current portfolio of lenders who have invested heavily in apartments since the early 1980s when lending institutions were deregulated.

- H.R. 3838 creates an imbalance between two sectors of the shelter industry. The homeowner sector retains most of its tax subsidies and the renter sector loses essentially all of its tax incentives.
- The rental housing industry and related industries have a significant impact on the nation's economy. Multi-family rental construction annually accounts for the generation of 1.1 billion of Federal, state and local taxes and generates approximately 2.2 percent of the Gross National Product. Adoption of the proposal would result in a tremendous loss of jobs and economic production in the rental housing industry as well as related industries which supply its goods and services.

Mr. Chairman and Members of the Senate Banking, Housing and Urban Affairs Committee, my name is Robert Sherman. I am President of the National Apartment Association.* I am also President of S&S Properties, Inc. in Dallas, Texas. I appreciate the opportunity to present the views of NAA concerning the impact of H.R. 3838, the Tax Reform Act of 1985, on the rental housing industry.

We have no doubt that H.R. 3838, the Tax Reform Act of 1985, would severely injure our industry. It would force production of rental housing to decline significantly, drive up rents, cause further deterioration of existing housing stock and force the private sector out of the rental housing market. In evaluating the changes proposed, the Administration and Congress are essentially giving notice that decent affordable housing is no longer a national goal. Direct government assistance for housing has virtually been wiped out. Now, the incentives for private industry to produce and maintain existing rental housing would be repealed.

When the Treasury Department's tax reform proposal was released in November 1984, NAA commissioned a study to assess the impact of the proposed changes in the tax code on the rental housing industry. This study (which did not consider the at risk and interest cap provisions) showed that rents would have to increase by 44 percent to make up for the loss of tax incentives as proposed in Treasury I.

When H.R. 3838 passed the House of Representatives, our economist analyzed the provisions using the same model used to evaluate earlier Administration proposals. Our study of H.R. 3838 shows that rents must increase 26 percent in order to offset the tax changes. For the average renter, rents will go up from $350 to over $440 per month while the average tax savings would be in the range of $7 to $15 per month or or $84 to $180 per year.

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* The National Apartment Association is a trade association representing over 200,000 multifamily professionals including owners, developers, managers and industry suppliers of over three million rental units and condominiums nationwide. NAA is headquartered at 1101 14th Street, N.W., Suite 804, Washington, D.C. 20005.

The economic analyses commissioned by NAA focused on several of the provisions of H.R. 3838:

- The lengthening of depreciation schedules
- The application of the at risk rules to seller-financed real estate transactions
- The limitation of the deduction of interest expense
- The repeal of the 10-year amortization of construction period interest and taxes, and
- The change in marginal tax rates

The following is a summary of the major effects on the rental housing industry if these provisions are adopted:

- To maintain the current yield for investments in multi-family property, rents on properties would have to increase by 18 to 26 percent (depending on inflation) on properties that are constructed after enactment of H.R. 3838.
- Investor/owners could experience declines in the value of their holdings by more than 16 to 21 percent (depending on inflation) unless rents increase significantly above inflation.
- New production of rental housing would decline sharply resulting in a housing shortage.
- In those particular developments where higher rents cannot be charged, the construction or rehabilitation of multifamily housing will not take place. The resulting shortage of housing will eventually drive rents up. Private industry will not be able to produce affordable, decent rental housing, particularly for those in income brackets that are least able to afford it.
- The lowering of the tax brackets and the expected lower tax for rental household families would be quickly absorbed by rent increases, thereby leaving renter households with less money for non-housing expenditures.
- The decline in rental real estate values could have a significant negative impact on loan to value ratios. This would increase the risk to the current portfolio of lenders who have invested heavily in apartments since the early 1980s when lending institutions were deregulated.

Although our studies show that rents would have to increase dramatically, it is doubtful that they would. Two market forces act to restrict increases in rent levels. The first is the income level of renter households. According to the 1983 U.S. Housing Survey, the median renter household income was approximately $13,400. These people cannot afford to pay higher rents.

Renters represent about 35 percent of all households in America. This translates to approximately 30 million households who choose to rent or find it necessary to rent in order to meet their shelter needs. The typical renter household devotes approximately 30 percent of its income to housing as compared to an owner household that devotes 18 percent of its income to housing and has a median income of $24,400. In 1983, 11 million renter households, or 37.5 percent of renter households, had incomes below $10,000. Their median gross rent as a percentage of income was 56 percent. On average, households with income under $10,000 spent over one-half of their income for housing.

The limited income is the principal reason that renter households spend a disproportionate share of their income for housing. Table I gives the latest available data for household income groups and their housing expenses as a share of income by tenure.

To the extent the tax incentives are repealed, rental income will have to increase to make up the shortfall in the rate of return. Consider the following example -- it is estimated that a married couple with an income of $25,000 would save $100 per year in taxes or $8 per month. Assuming market forces would allow for only a ten percent increase in rent on a $350 per month apartment, the increase would be $420 per year or $35 per month. This household's net cash position would be worse, and their tax savings would be absorbed within three months by rent increases. Clearly, tax reform will not benefit this renter household when all the costs and savings are tallied.

A second market factor that restricts rent increases is the favorable tax treatment of single-family housing. To a large extent, rents are limited by the minimum price of ownership housing with its tax advantage of the mortgage interest deduction, irrespective of the costs of providing rental housing. H.R. 3838 creates an imbalance between the two different sectors of the shelter industry. The homeowner sector retains most of its tax subsidies, the mortgage interest deduction and the nontaxable "imputed" value of rent. At the same time, the renter sector loses essentially all of its tax incentives.

The unfairness of this tax subsidy imbalance in favor of home owners is aggravated by H.R. 3838 because it caps the interest deduction on investment in rental housing while it permits the full deductibility of interest on a vacation home.

The subsidy in the tax code for shelter is tilted away from those in need toward those with the highest income and most expensive shelter.

With rent levels restricted by the income of the poor and the ability of the upper bracket residents to buy, our industry must operate within narrow boundaries. The rental income plus the expected capital appreciation of the property do not provide an adequate return to investors. The incentives provided by the tax code make the difference when the decision to build or not to build is made. In other words, the tax incentives allow rents to be more affordable. Without tax incentives there will be a halt in multifamily housing construction and rehabilitation. Only those complexes where sufficient rents could be charged would be constructed. Housing in low-and-moderate income communities would suffer.

The multifamily rental industry not only competes with the single-family industry, but it must compete with commercial real estate for investment capital. Because we are in the business of providing housing, the Committee must make a policy decision whether to continue to give more tax advantages to multifamily housing. Commercial properties generally have a greater ability to raise rents because commercial tenants can pass through their costs. In multifamily housing we are dealing with the ultimate consumer -- the lowest income Americans -- who cannot absorb rent increases without lowering their standard of living.

The tax code has provided additional incentives to housing in the past. Depreciation schedules prior to 1981 as well as under the Economic Recovery Tax Act (ERTA) were more favorable to housing. Faster schedules and more lenient recapture rules were permitted. We urge Congress to recognize the special needs and problems that the multifamily rental industry has.

Decent affordable housing has been a national goal. This country has and will continue to assist the poorest segments of our population by providing food, shelter and medical care. These are basic needs. As an industry spokesman with experience in the private sector of the housing industry, I can assure you that the private industry can build and operate an apartment complex much more efficiently than the government. On an average, private industry can build an apartment unit for $30,000. The cost, when government does it, rises to $50,000-$60,000 per unit. Assuming this country will continue helping to house our poorest people, consider the cost of using tax incentives to produce housing versus direct subsidies. The cost to the government is far less when private industry produces the housing for our citizens.

Mr. Chairman, political realities have forced the housing industry to look to the tax code as the vehicle for providing the assistance we need so that affordable housing can be available for Americans. Direct appropriation programs, especially for our poorest income households, will always be necessary. "Tax shelters" are not just loopholes for the wealthy to avoid paying taxes. Instead, these "shelters" make it possible to build and rehabilitate housing for low-and-moderate income Americans that would be economically impossible without tax incentives provided through the tax code. These tax incentives, including the Accelerated Cost Recovery System (ACRS) of depreciation, the full deductibility of interest expenses, the non-applicability of the at risk rules to real estate and the use of tax-exempt housing bonds have been the lifeblood of our industry. The preservation of these tax incentives is essential to ensure that affordable rental housing will continue to be produced by the private sector.

In addition to the concerns about housing, the economic impact that our industry has on the economy should not be overlooked.

If the current tax laws remain intact, an estimated 500,000 units will be added annually to the rental stock in the decade of the 1980s. The construction of 450,000 multifamily rental units last year produced about 371,000 man years employment for workers in the construction industry. These workers earned $7.7 billion in wages and salaries in 1984. Multifamily rental construction annually accounts for the generation of $1.1 billion of Federal, state and local taxes.

In addition to construction, in 1983 the rental housing industry generated $74 billion (excluding new construction) or

2.2 percent of the Gross National Product. The rental housing industry employs approximately one million full-time employees (excluding construction).

If H.R. 3838 is adopted, the reduced investment in multifamily construction would cause a tremendous loss of jobs, economic production in the construction industry and in industries that supply the housing industry. It would also lead to housing shortages in the near future.

The following is a summary of the major provisions of H.R. 3838 that adversely affect the housing industry:

DEPRECIATION

The depreciation schedule for real estate would be lengthened from 19 years at an accelerated rate to 30 years at a straight-line rate. The basis of the property would be adjusted for inflation. The adjustment would be one-half of the amount that inflation exceeds five percent. Commercial and market rate residential property would be treated the same.

Residential rental property that agrees to set aside either 25 percent of the units for residents who have incomes that do not exceed 80 percent of the area median, or 20 percent of the units for residents who have incomes that do not exceed 70 percent of the area median income, would be eligible to adopt a 30-year 200 percent declining balance, switching to a straight-line depreciation schedule. A third very low-income housing category would be created that allows a 20-year, 200 percent declining balance schedule for those projects that set aside 40 percent of the units for residents who have incomes that do not exceed 60 percent of the area median income.

The lengthening of the depreciation schedule would have the greatest dollar impact on our industry. The value of the tax incentives of a 19-year accelerated rate is much greater than that of a 30-year straight-line rate. This is particularly true in the crucial early years of a building. In order to compete in the capital markets with the other types of investments, particularly commercial property, housing needs a shorter depreciation period at an accelerated rate. Residential rental property requires a longer lease-up period than does commercial office space. Therefore, the income stream is less in the earlier years. An accelerated depreciation schedule affects the negative cash flow in the early years.

In terms of the attractiveness of an investment, residential property also suffers under several disadvantages. Due to the income levels of residents, cost increases cannot be readily passed through. The possibility of rent control exists. There are additional restrictions placed on property owners in the areas of evictions and bankruptcy.

Due to these problems, housing has had a tax advantage over commercial office property. Under current law, as well as before 1980, residential property was entitled to a more accelerated depreciation schedule. H.R. 3838 removes this advantage for most residential property.

There is a social objective that is served by providing incentives to provide housing to Americans. NAA supports this goal and we think that providing housing serves a greater social purpose than providing office space. We urge Congress to maintain some advantage for housing over commercial office space.

INTEREST EXPENSE

The interest expense deduction would be limited to net interest income plus $10,000 for single taxpayers and $20,000 for taxpayers who file jointly. The cap would be phased-in over ten years. The cap would not apply to interest on mortgages on primary residences or second homes.

The interest caps would treat the interest expense of a limited partner in a limited partnership as investment interest and, therefore, subject to the cap. The interest expense of an active trade or business would not be subject to the cap.

The real estate industry relies on borrowing a significant portion of the purchase price of the property. It is common to borrow up to 80 percent of the proceeds under a long-term debt agreement. Lenders are willing to allow loans to value ratios of 80 percent because they have the security of the real property. Because high leverage is the norm in real estate transactions, the interest cap is especially harmful to the industry. If borrowing is restricted and more equity is required, greater rates of return will also be required. This will place further upward pressure on rents.

ALTERNATE MINIMUM TAX

The Alternate Minimum Tax (AMT) provisions of H.R. 3838, the Tax Reform Act of 1985, would create very burdensome problems for the multifamily housing industry. In addition to raising the AMT rate from 20 to 25 percent, the bill subjects several new items to the AMT.

Under current law, there are two major tax preference items that affect the real estate industry -- accelerated depreciation in excess of straight-line depreciation and the capital gains exclusion. With regard to accelerated depreciation, for property placed in service after December 31, 1985, the excess depreciation to be taxed under the AMT would be the difference between the depreciation taken and the depreciation that would be allowed using a 40-year straight-line rate. The capital gains exclusion would continue to be subject to the AMT.

The AMT provisions of H.R. 3838 would also tax (1) losses from passive activities that exceed the lesser of the taxpayer's cash basis in the activity or $50,000 and (2) interest income from tax-exempt bonds for non-essential functions.

Excess Passive Activity Loss

The deduction for excess losses from a passive activity would be denied in the calculation of income subject to the AMT. A passive activity is one in which the taxpayer does not materially participate in or provide substantial personal services for the activity. Most real estate limited partnerships would be considered passive activities. Passive activity losses are defined as the amount that aggregate losses exceed aggregate income from passive activities. Excess losses are the amount by which the passive activity losses exceed the taxpayer's cash basis in the passive activities.

In the case of passive activity losses that are derived from tax shelters, the aggregate deduction for purposes of calculating the AMT cannot exceed $50,000 regardless of the taxpayer's losses from the passive activity or his cash basis. Actual losses would not be deductible and therefore taxed. Also note that the $50,000 cap applies to all of the taxpayer's passive losses. It is not a per activity cap.

For example, a taxpayer invests $75,000 in a limited partnership. The losses of the limited partnership allocable to the taxpayer are $90,000. The taxpayer could only deduct $50,000 of the loss for purposes of calculating income for the AMT. Had the taxpayer invested $25,000, then his deduction would be limited to $25,000, his cash basis.

This provision to tax certain losses under the AMT would apply to existing transactions because it requires the aggregation of all passive investment losses.

Rate Compression

A significant adverse impact of the AMT proposal would result from the compression of the maximum tax rates. Because the differential between the top regular rate of 38 percent and the top AMT rate of 25 percent is so small, many more taxpayers will be subjected to the AMT. Under current law, the difference between the top regular rate (50%) and the top AMT rate (20%) is significant. The AMT rate is only 40 percent of the regular rate. Therefore, a taxpayer has considerable leeway before becoming subject to the AMT. Under H.R. 3838, the AMT rate is 66 percent of the regular rate. It will not take very much preference income to become subject to the AMT. This condition will force investments to be judged on their after-AMT (worse case) rate rather than using the regular tax system.

TAX-EXEMPT HOUSING BONDS

In today's high interest rate environment, tax-exempt bond financing is an essential tool to reduce the debt service sufficiently to make the transaction "pencil out." It is estimated that 50 percent of the multifamily housing production in 1982 used tax-exempt financing. In 1983 and 1984 that figure was in the 22 to 24 percent range. Without the ability to reduce the debt service expense by 200 to 300 basis points, many of those apartment developments would not have been built.

The restrictions proposed in H.R. 3838 on the use of tax-exempt financing for multifamily housing would curtail production. Because of the low-income set-aside requirements to obtain bond financing, the greatest impact would be on the residents who can least afford it.

In addition to further restricting the requirements to issue tax-exempt housing bonds, H.R. 3838 would subject the interest income from these bonds to the Alternate Minimum Tax (AMT). Making non-essential purpose bonds taxable under AMT would force those bonds to yield a higher return in order to compensate for the AMT. It is very likely that an investor in tax-exempt bonds would be subject to the AMT. Yields on tax-exempt securities are lower because they are tax exempt. The lower interest cost benefits the housing industry. The taxation of these bonds will force their yields upward.

RAPID AMORTIZATION OF COSTS

Current law allows the rapid amortization of certain expenses that encourage construction and rehabilitation of real estate. The repeal of the 10-year amortization of construction period interest and taxes would require that these expenses be amortized over the life of the building -- 20 years.

The shortened amortization period provides an incentive to build and rehabilitate. Although this item does not have a large dollar value impact, it enhances our industry's case that real estate is bearing an excessive burden of the so-called tax reform effort.

EFFECTIVE DATES

The provisions of H.R. 3838 take effect on January 1, 1986. Because this date has passed and the bill is pending in the Senate, the provisions will take effect retroactively, i.e., the provisions would take effect on a date earlier than the date the legislation becomes law.

Any legislation that contains retroactive effective dates creates several problems. When the legislation is as broad in scope and as drastic as H.R. 3838, the situation is aggravated. During the period of time between the effective dates of the proposal and final passage, the affected industries must continue to make business decisions. The uncertainty created by the retroactive effective dates has scuttled many real estate transactions. The tax impact of H.R. 3838 on the housing industry is so great that pre-1986 transactions will not be feasible under the Tax Reform Act of 1985. To compound the uncertainty, it is likely that the Senate will alter several of the provisions of H.R. 3838.

Due to the uncertainty that Congress has created, the real estate industry and the construction of rental housing has declined. Only those developments that are "grandfathered" are under construction.

Congress should delay the effective date of any tax reform legislation until January 1, 1987 or the date the legislation is signed into law. All industries must plan ahead to be successful. This is particularly true for the real estate industry because of the construction period. It is unfair to the business community to leave it in limbo. There have been three major tax laws since 1980 (ERTA, TEFRA and TRA of 1984). American business needs certainty, clarity and fairness. Retroactive effective dates combined with the constant changing of the tax laws is unfair and unproductive.

In light of our national priority to provide decent and affordable housing to all Americans, NAA urges Congress to preserve the tax incentives for capital formation in the multihousing industry in any overhaul of the current tax system. These incentives have kept the industry alive and have helped make the United States the best-housed nation in the world. They should be preserved and strengthened.

Private capital formation is essential to economic growth. The multihousing industry had just begun to reap the benefits of the positive changes enacted by Congress in 1981. The Economic Recovery Tax Act of 1981 provided some security to the rental housing industry by creating tax incentives which were designed to stimulate the economy. However, since that time Congress has consistently taken away these incentives through the Tax Equity and Fiscal Responsibility Act of 1982 and the Deficit Reduction Act of 1984. The trend seems to be to focus on the real estate industry to make it bear an overwhelming and unfair portion of the burden of repaying the Federal deficit.

Critics focus on the high returns received by successful real estate ventures, but capital investment in real estate is very risky. This risk is often forgotten because failures in real estate are not newsworthy unless a whole state's savings and loan industry is imperiled by "risky" real estate investments as happened in Maryland.

In the multifamily area, there are very unique risks including political interference with rights of ownership such as rent control, local taxation at discriminatory rates, substantial tax preferences for ownership housing and bankruptcy laws that treat rents differently than other debts. Because renters cannot afford rents sufficient to generate a rate of return commensurate with the risk of the investment, tax incentives are necessary. The alternative is for the government to spend billions for direct housing subsidies.

Frequent modifications of the tax code create uncertainty in the market and prevent long-term planning, an integral component of real estate investing. Furthermore, since the return on investments in rental housing is diminishing due to increasing maintenance costs and other factors, investors will begin to look elsewhere for investments that are more fruitful and more secure. The rental housing industry cannot withstand and survive continued changes in the tax code which draw more and more potential capital away from the industry.

Mr. Chairman, the rental housing industry has already begun to feel the effects of H.R. 3838. Our members across the country have witnessed an increasing loss in the vitality in the industry under the shadow of further detrimental changes to the tax code. On behalf of the National Apartment Association and also of the residents we serve, I urge the Committee to examine and recognize the impact of each of the provisions of H.R. 3838 and to work to preserve the essential tax incentives which have been the mainstay of the industry.

NAA would be pleased to offer our assistance in establishing a coherent effort to assure that any tax reform package which may come before the Congress actually promotes fairness, simplicity and economic growth.

Mr. Chairman and Members of the Committee, I thank you for allowing me the opportunity to express our views. I would be happy to answer any questions which you have at this time.

TABLE I
Household Income and Median Housing Expenses
as a Percent of Household Income (1983)
Renter versus Owner Households

	Renters		Owners	
Income	% of total	median gross rent as a % of income	% of total	median housing expenses as % of income
10,000	37.5	56	13.0	41
10-14,999	18.2	32	9.4	24
15-19,999	13.6	26	9.3	29
20-24,999	9.5	21	9.8	20
25-34,999	12.1	18	21.2	17
35-49,999	6.3	14	20.2	14
50-74,999	2.1	12	11.8	12
75,000	0.7	10	5.3	9
Total	100.0		100.0	
Median Income	$13,400		$24,400	

Source: U.S. Bureau of Census and
HUD 1983 Annual Housing Survey

TABLE II
Cumulative Effects of President's Proposal
Mortgage Interest Rate = 14 percent

Holding Period	8 years		18 years	
Inflation Rate -	4%	6%	4%	6%
A. Rental Income as % of Total Development Cost required to produce ATIRR of 15%	21.4	17.4	20.6	17.1
B. % Change in rent required to produce ATIRR of 15%	+12.6	+18.4	+17.7	+22.1
C. % Change in value from base before any rent increase above assumed rate of inflation	-11.7	-15.6	-15.0	-18.3
D. ATIRR before any rent increase above assumed rate of inflation	+12.1	+11.8	+11.8	-12.4

The CHAIRMAN. Thank you. Mr. Driesler.

STATEMENT OF STEPHEN D. DRIESLER, EXECUTIVE VICE PRESIDENT, NATIONAL MULTI HOUSING COUNCIL

Mr. DRIESLER. Thank you, Mr. Chairman. My name is Stephen Driesler. I am the executive vice president of the National Multi Housing Council.

The National Multi Housing Council [NMHC] is a trade association which represents over 6,000 builders, owners, developers of rental housing throughout America. Because we represent many of the Nation's largest owners of rental housing, NMHC represents several hundred thousand units of rental housing throughout the Nation. One of the disadvantages of coming last on a distinguished panel of this nature is that most of the information, most of the concerns that I had set forth in my testimony have already been addressed. Therefore, rather than repeating many of these concerns, I would like to use this opportunity to sort of summarize what I feel are the concerns of the rental housing industry which have been expressed by many of the panelists.

Virtually every economic analysis that I have seen of the tax reform proposals from Treasury I to the President's proposal to H.R. 3838, have come forward with these conclusions as they relate to rental housing.

No. 1, it will increase the cost of capital and, therefore, will reduce sharply new construction of rental housing for a short period of time. The period of time could run anywhere from 5 to 10 years. That is depending upon the second factor. Because of the decreased supply of rental housing and because of supply and demand forces, eventually rents in rental housing would increase, as Mr. Sherman testified, anywhere from the midteens to the upper 20 percent.

Most all the economic analyses have projected increases over the next 5 years of somewhere in the average of 20 percent above what they would be, absent changes in tax reform.

Now these two changes, the decrease in new construction and the increase in rent create two problems which I think this committee is legitimately concerned about and ought to be addressed in the Finance Committee, as they consider marking up any tax reform proposal.

BOND MARKET IS COMPLETELY DEAD

First let me address the sharp decline in new construction. Now Mr. Chairman, we are not talking simply about economic projections of decline. As you have heard from testimony by this panel and other panelists today that the tax-exempt bond market, which last year contributed about 25 percent to the construction of new rental housing is virtually—not virtually—is completely dead in the water until something can be worked out on the effective dates placed in H.R. 3838.

So you've one quarter of the new construction of rental housing presently absolutely dead.

I have a letter which I would like to read for the record from one of my members, the Balcor Co., which, depending on whose figures you believe, is either the first or second largest public syndicator in the country.

Because of their size, they also have become one of the largest owners of rental housing and one of the largest purchasers of newly constructed rental housing in the country.

Let me read you this letter, briefly.

> Dear Steve,
>
> The following represents the number of units that Balcor contracted with developers to construct for the years 1982 to 1985. We typically inventoried these properties for eventual placement 1 to 1½ years hence in one of our public or private limited partnerships.
>
> In 1982, we contracted for new construction, 7,205 units; in 1983, 20,288 units; in 1984, 12,493 units, and in 1985, 896 units.
>
> For the same years we received the following increases in the amount of funds raised through public and private partnerships.
>
> In 1982, $300 million; 1983, $600 million; 1984, $755 million, and 1985, $948 million.

They go on to explain:

> The decline in 1984 units was largely attributable to the uncertainly caused the first half of the year by the 1984 tax bill. The dramatic decrease in 1985 was due to the uncertainty created all year by the tax reform debate.
>
> The two sets of figures make it abundantly clear that while we have rapidly increased the funds raised the last 4 years, the proceeds are being invested in existing structures. This is obviously not helping the economy or creating new jobs. Until the current tax situation is clarified, we do not intend to change this investment strategy.

Now here is one example, a real-life example of a major purchaser of new rental housing who has, in essence, over the last year decreased their new rental construction by over 90 percent.

Now what does this mean in real terms? When my members are not building new rental housing, they are not hiring carpenters, they're not hiring brick masons, they're not hiring plumbers, or electricians, or any of the other labor force that goes into building these properties. They're not buying the lumber, they're not buying the paint, they're not buying the carpet, they're not buying the refrigerators, and the other appliances that go into making up a modern apartment house complex, and that has a ripple effect throughout the economy. Because, when those plumbers and electricians don't have as much work, they don't have as much disposable income to spend on clothing, or new cars, or television sets, or VCR's, or any of the other consumer goods or services upon which the economic health and welfare of our economy is dependent.

By the same token, the lumber dealers and the plumbing supply people don't have as much business. They also have a ripple effect throughout the economy.

We're already seeing this happen just because of the uncertainty created by H.R. 3838 and its passage in late December of last year. If the Senate were to pass a tax reform bill similar to the H.R. 3838 or the President's proposal, we would see this trend not only continue but intensify.

RENT INCREASE

The second trend that all economists have agreed would happen with the adoption of either H.R. 3838 or something similar to

Treasury I or the President's proposal, is an increase in rents, an increasing order of magnitude of 20 percent over the next 5 years.

As Mr. Sherman has already pointed out, renters in this country pay a significant higher percentage of their income in rent than they do in Federal income taxes. Therefore, even a relatively small increase in the rents they have to pay more than offsets a much larger percentage decrease in their effective tax rate.

And what you will eventually find is that your renter constituents will have maybe $100, $200 of tax refund in one pocket, but it's going to be eaten up in rent increases, more than eaten up in rent increases over the next 3 to 5 years. I think it's going to be difficult to convince them that they are better off economically in the long run.

And what about those tenants, Mr. Chairman, who cannot afford those rent increases? This committee knows better than any other in Congress the problems associated with the Federal deficit and increased funding direct subsidies, any type of housing subsidies for the needy.

In the next few years, when those tenants who cannot afford rent increases come to Congress and ask for more direct subsidies, whether it be housing vouchers or something like a section 8 program, and yet we still have the problem with the Federal deficit, what is this committee to do? That is the dilemma, very realistically, this committee will have to face and the Congress will have to face, if the type of tax reform provisions that are detrimental to rental housing are enacted into law.

Another problem which this committee has some direct interest in, obviously is the health of the financial institutions. I was talking to another one of our members just this week who told me of a private syndicator in the Southeastern part of the United States who is sitting on the verge of bankruptcy today, because four deals which he put on the market in the latter part of last year were not sold out and will not sell out. The market for those have simply dried up, due to the effective date of—January 1, 1986, contained in H.R. 3838.

But not only is this company looking at bankruptcy, the major financial institutions which loaned this company the money to buy these projects is also facing grave financial risk, if this company cannot make it.

So you have not only the risk to the developer and to the investors who will lose their investment, if this company goes bankrupt, but the financial institutions who help underwrite the projects is also threatened, should this effective date situation not be clarified in the very, very near future.

To address some of the key issues very briefly that the National Multi Housing Council is concerned about, you have already heard a lot of testimony concerning tax-exempt bonds today. The only point I would like to add to that has to do with the volume cap. Mr. Chairman, as a mayor you know, housing needs do not simply translate throughout a State or throughout the country or even within a State or a locality, strictly based upon population. One city of 1 million people may have a vacancy rate of 10 or 12 percent. A similar-sized city in another part of the State or in another State, could have a vacancy rate of 2 or 3 percent.

INEQUITIES IN THE ALLOCATION OF MONEY

Clearly the city with the lower vacancy rate needs much more rental housing than does the former. Yet, under the present bond cap, they would be given roughly equal treatment. That system is not workable. The marketplace is the only truly efficient and rational distributor, based upon housing need and what the market will support. Therefore, we would like you to consider the implications of what a volume cap does in artificially restricting legitimate housing needs in some communities while supplying other communities with bonding volume which perhaps is not needed.

Depreciation is another major concern. While a great deal of the testimony today has focused on the debt side of producing multifamily housing, we cannot ignore the equity side, because our members must raise the equity capital to make these projects go forward, and without the depreciation benefits, without the ability to write off legitimate interest paid, whether you classify it as an investment interest, or trade, or business interest, it is legitimate out-of-pocket expense of operating a rental housing project and with the minimum tax provisions that takes passive losses, including real economic losses, and taxes them, all of these factors raise the cost of capital for multifamily housing and makes many of these projects, even if you preserve the debt side, financially unfeasible, simply because you're not able to attract the equity or the equity at a price which makes the project financially doable.

I would like to reiterate the importance—Mr. Sherman touched on this—that rental housing has traditionally had a differential, in terms of depreciation vis-a-vis other forms of real estate. This differential was not put into the code arbitrarily. It was put in there because very sound facts and circumstances of the world dictated that it was fair and reasonable.

Let me give you another example. I had a major developer of mine run an analysis, and these people develop both commercial property and rental housing. They did an analysis of what they call their free and clear cash-flow of commercial property versus the free and clear cash-flow of their rental housing projects.

The free and clear cash-flow, very simply, is your income, minus your expense of operation, not counting your debt service, because that debt services varies so much, it's hard to compare apples and apples. So it's strictly your income minus your operating expenses.

The average free and clear cash-flow for a commercial project was 13.8 percent. The average free and clear cash-flow for a typical rental project was 8.5 percent. Now there are three elements to a real estate investment. There is cash-flow. There is tax benefits and there is appreciation. If you basically hold the appreciation potential equal, you're left with cash-flow and tax benefits.

And if one type of property, commercial property, can consistently offer about 160 percent higher cash-flow than can residential property, unless there is a corresponding tax benefit in favor of rental housing, any prudent investor looking at two projects is going to say, I've got the same tax benefits, I've got the same appreciation potential, but yet I've got a higher probability of tax flow, particularly in the early years from a commercial project, therefore, it makes sense to me, as a prudent investor, to put my money into a commercial project vis-a-vis rental housing.

Now we're not talking about stacking the deck in favor of rental housing, let me make this clear. What we're talking about is keeping the playing field equal, and where we are, the differential that is—under current law keeps rental housing on a relatively equal playing field with commercial investments, and we need, and it's essential that rental housing keep that same relative differential under any new depreciation scheme that the Senate or the Finance Committee enacts.

That was not the case in H.R. 3838, where rental housing was given the same identical treatment as other forms of real property.

In closing, Mr. Chairman, let me again compliment you and this committee. Those of us who have been involved in the tax reform process on the House side during the last year have found it frustrating to deal with tax writing committees who are, in fact, now setting national housing policies and yet historically have not delved into the public policy reasons that go into establishing national housing policy that this committee and its counterpart on the House side has done.

We think it's appropriate, in fact, vital and necessary that this committee make its views known to the Finance Committee in developing a tax policy which also is a rational housing policy.

Thank you very much.

[The complete prepared statement follows:]

NMHC
NATIONAL MULTI HOUSING COUNCIL
Suite 620 • 1250 Connecticut Avenue, N.W. • Washington, D.C. 20036 • (202) 659-3381

STATEMENT OF STEPHEN D. DRIESLER
ON BEHALF OF THE NATIONAL MULTI HOUSING COUNCIL
BEFORE THE COMMITTEE ON BANKING HOUSING AND
URBAN AFFAIRS
UNITED STATES SENATE

FEBRUARY 6, 1986

STATEMENT OF STEPHEN D. DRIESLER
ON BEHALF OF THE NATIONAL MULTI HOUSING COUNCIL
BEFORE THE COMMITTEE ON BANKING HOUSING
AND URBAN AFFAIRS
UNITED STATES SENATE

FEBRUARY 6, 1986

Mr. Chairman, and members of the Committee on Banking Housing and Urban Affairs, my name is Stephen D. Driesler and I am the Executive Vice President of the National Multi Housing Council which represents over 6,000 developers and owners of rental housing nationwide. Our members are engaged in all aspects of the rental housing business and are responsible for hundreds of thousands of dwelling units.

I would like to thank you for the opportunity to appear before you today to express our concerns regarding H.R. 3838. Because it substantially eliminates tax incentives currently in the law, H.R. 3838 would significantly increase the cost of capital needed to finance new rental housing. Thus, the likely consequence of the House tax bill would be a sharp decrease in new construction of rental housing, leading to a renewed rental housing shortage and rent increases estimated at more than 20% above currently anticipated levels after five years. This dramatic increase is particularly significant since the median income of renters is approximately one half that of homeowners, and thus this burden falls on those least able to afford it. Accordingly, the National Multi-Housing Council believes that the

House bill would be devastating to the rental housing industry, would seriously impair our nation's ability to provide decent and affordable housing to lower income families and would ultimately cause rent increases which would far outweigh any tax cut savings provided to the renter population.

Mr. Chairman, until now this country and its Congress have made decent housing a national priority through a combination of direct subsidy programs and federal tax incentives. As you know, direct housing subsidies have now been virtually eliminated under federal budgetary constraints. H.R. 3838 would complete the reversal of this national priority by not only eliminating the positive tax incentives which have historically been provided for the production of rental housing but also actually preventing owners of rental housing from deducting the direct expenses of their business venture on their federal income tax returns.

Traditionally, private investors acquire or develop rental housing using a partnership structure. These owner investors participate financially in all aspects of the rental housing business, and they report all income and expenses on their federal tax returns. H.R. 3838 contains two provisions which would prevent owner investors from deducting the legitimate costs of operating a rental housing business. Such a disallowance is unprecedented in our tax structure which has always recognized that direct business expenses are necessary deductions in arriving at taxable income. To disallow such deductions is to transform an income tax into a gross receipts tax, and H.R. 3838 not only does so, but does no inequitably by singling out only certain businesses which operate in partnership form, such as the rental housing industry, thereby disadvantaging housing vis-a-vis alternative investments.

First, H.R. 3838 extends the limitation on the deduction of investment interest to any interest allocated to owner investers in rental housing partnerships, except for those investing in bond-financed low income housing projects or very low income housing projects, merely because they do not actively manage the property. In addition, this proposal would be phased in over a ten year period; and thus, it would apply equally to new and old investments -- investments made in the fair and accurate expectation that these costs could be deducted. Accordingly, actual mortgage interest payments which are generally the single most significant expense of any real estate business would not be deductible for federal income tax purposes unless the owner has sufficient investment income to offset this expense. Clearly, the pool of investors who will be attracted to rental housing operations will be drastically limited, and those investors who currently own rental housing will be exposed to excessive tax liability as this provision phases in, creating increasing incentives to terminate these investments and to withdraw essential capital from existing housing stock.

Second, the new alternative minimum tax provision treats net losses from partnership investments as a tax preference subject to a 25% tax rate without exception for those expenses which are the direct operating costs of an active business venture. In fact, because the alternative minimum tax already separately taxes deductions such as accelerated depreciation which are not current cost items, the remaining items which fall into the net loss category are certain to be direct expenses. These "tax preference" expenditures will include mortgage interest and state and local property taxes as well other direct operating costs which are not offset by rental income. The National Multi Housing Council believes that it is contrary to our nation's fundamental tax policy to tax the owners of rental housing on the amounts which they have spent to operate their businesses.

Because the renter population consists primarily of lower income families who cannot afford to pay high rents, rental housing generally does not produce enough income in the early years of its operation to offset the costs of operating a project. By using a minimum tax to deny investors who have forgone positive cash flow return the benefit of the federal income tax deduction for the costs of their venture, the tax bill will so drastically reduce the rate of return available from investments in housing as to make housing, with the exception of housing designed for the affulent luxury market, entirely uncompetitive and unable to attract private investment capital until rents rise to levels beyond the reach of lower income Americans.

In addition, H.R. 3838 would increase not only amount of income subject to minimum tax for individuals and corporations but also the minimum tax rate. Because the proposed 25% minimum tax rate is more than 65% of the proposed maximum regular income tax rate of 38%, many more taxpayers would be affected by this new minimum tax than are affected by the current 20% minimum tax, which is only 40% of the regular rate. Moreover, because significant personal itemized deductions such as the deductions for state and local taxes and nonmortgage personal interest are disallowed or severely curtailed for minimum tax purposes, many taxpayers would be threatened with new minimum tax liability even if they have little or no genuine tax preference income.

Moreover, this new alternative minimum tax preference is fully retroactive in that it applies to losses from existing investments where the owner may be locked in. Thus, investors who legitimately relied on the tax laws in selecting their investments will be unjustly penalized for producing rental housing in the past or forced to withdraw their existing equity. Taxpayers who are subject to this broadened minimum tax would not be able to utilize any additional tax benefits including benefits from existing investments. Accordingly, even those tax incentives for the production of very low income housing, which the Ways and Means Committee was careful to preserve after extensive negotiations, could be rendered useless by the operation of this only nominally "minimum" tax.

Finally, H.R. 3838 eliminates the favorable differential which has traditionally been accorded to investments in housing vis-a-vis other investments in real estate. Congress has always recognized that commercial real estate can generate higher cash flows than rental housing because commercial tenants can afford more substantial rents than can lower income families. Because the tax bill eliminates any differential between conventional rental housing and commercial property, the National Multi Housing Council believes that whatever private investment capital continues to flow into the real estate industry will be invested in commercial real estate -- office buildings, shopping centers and the like -- rather than in rental housing. The lack of private capital will not only curtail new production but will make it impossible to renovate and maintain existing housing stock which is, or becomes, in need of substantial rehabilitation. Accordingly, this nation will not only forego the creation of new housing but will also lose much of its existing stock and will go from being the best housed country in the world to one of the worst.

I would like to summarize our further specific concerns about H.R. 3838:

Even for those investors who can benefit from tax incentives despite the limitations of H.R. 3838, the tax incentives for investment in rental housing are sharply reduced under this legislation. Specifically, H.R. 3838 lengthens the depreciable life of real estate from 19 to 30 years and mandates the use of straight line depreciation except in the case of targeted low income housing. Moreover, H.R. 3838 applies new targeting requirements to tax-exempt bond financed housing for low and moderate income families, subjects these obligations to new overall statewide volume limitations and includes interest on these bonds under the new alternative minimum tax for both individuals and corporations so that a taxpayer subject to minimum tax would pay a 25% tax rate on the income from these obligations. Further, uncertainties over the effective date of the House bill combined with ambiguities concerning certain of its terms, such as the duration of the qualified project period and the application of the 5 percent expenditure requirement, would make continued supply and orderly issuance of these IDBs virtually impossible.

The National Multi Housing Council believes that the combined effect of the curtailment of tax incentives for the production of rental housing and the limitation on investors' abilities to utilize the remaining benefits would make it impossible for rental housing to attract private investment capital in the near future. As a result, only when a shortage of rental housing has forced rents to levels which can support dramatically increased financing costs would any significant housing production resume. Clearly, the greatest impact of these developments would be on the poorest renters.

The **Chairman**. Thank you very much, gentlemen. We appreciate your testimony. You've added a great deal to our hearing record, and after the comments of some of the first witnesses, we have checked with the Finance Committee, and whoever was making comments that they were going to ignore us is not representative of the committee. We do have two members of the Finance Committee who also serve on this particular committee, and we will make certain that our hearing record is available to them.

Senator Riegle had to leave. I would include a statement in the record for him. He also has some questions for your response in writing.

Thank you very much.

OPENING STATEMENT OF SENATOR REIGLE

Senator **Riegle**. Mr. Chairman, I want to thank you for scheduling this important hearing today.

In recent years, the Tax Code has been expected to bear an increasing share of the responsibility for meeting national priorities. That is especially true in areas of public policy falling under the jurisdiction of this committee—housing, urban development, and economic development. Perhaps that was inevitable as budgetary pressures fell most heavily on spending and urgent national needs continued to be felt.

As a result, it has become very difficult for Congress to be coherent in its approach to vital areas of public policy. This committee and other authorizing committees often find that important matters over which they have jurisdiction are more profoundly affected by changes in tax policy than by the committee's own decisions.

This series of hearings can't resolve those problems. But these hearings do help us gain a better understanding of how all of the decisions now pending before the Senate—tax reforms, Federal spending, and regulatory policy—affect the vitality of State and local government within our Federal system, the economic health of our Nation's cities, and smaller communities, and the affordability of decent housing for all Americans.

I am particularly impressed with the witnesses who have agreed to testify before us today. I welcome them and look forward to hearing their views.

The **Chairman**. Our final panel today will be composed of Robert W. Maffin, executive director of the National Association of Housing & Redevelopment Officials, Mr. Roderick Heller III, president, National Corporation of Housing Partnerships, and Barry Zigas, president, National Low Income Housing Coalition.

Is Mr. Maffin here?

[No response.]

The **Chairman**. Mr. Heller, we'll begin with you.

STATEMENT OF J. RODERICK HELLER III, PRESIDENT, NATIONAL CORPORATION OF HOUSING PARTNERSHIPS

Mr. **Heller**. Thank you, Mr. Chairman, I'm pleased to be before the committee today.

I am president of the National Corporation for Housing Partnerships, which is the largest owner and operator of low- and moderate-income housing in this country. We have 80,000 units, almost all of which were constructed or acquired pursuant to Federal assistance programs. We are also the largest manager of low- and moderate-income housing in the country, operating in 39 States with over 50,000 units under direct management.

We have preserved the nearly 500 projects under our stewardship by significant financial expenditures. We've invested over $40 million in advances and loans for operating deficits and otherwise to maintain the viability of prospects that otherwise would not have survived. We have never returned a project to HUD. We are very proud of this record, and it's one that I would like to emphasize to this committee, because today we want to stress a role somewhat different than that stressed by previous witnesses. We want to speak to the need of preservation of our existing stock of housing.

PRESERVATION OF EXISTING STOCK HOUSING

As you may know, Mr. Chairman, our company was created by Congress to stimulate the construction of low- and moderate-income housing. We are thus unique as a quasi-public entity, owned privately, but formed to fulfill a public purpose. We have, by virtue of the virtual elimination of subsidies and the threat of tax reform, been required to confront our own corporate future.

Now I'm here today not to speak about the impact on our company, but rather the impact on our constituents. Our company can survive regardless of the impact of tax reform. We, however, are concerned about our constituents, the low- and moderate-income tenants who, effectively, have no voice in the considerations before you.

There are approximately 600,000 units in private hands which were built under sections 236 or 221(d) programs. There are nearly 2 million units that were constructed pursuant to section 8. The units in the former category, section 236 or 221(d)(3) are typically 10 to 15 years old and require significant additional expenditures.

We are very worried about the impact of H.R. 3838 on those units simply because, without tax assistance, there is no way to assure the continued retention of those units for low- or moderate-income purposes. We have, in the last 3 years, acquired 95 projects that were originally constructed by other entities under those various programs. We've invested $8.5 million to upgrade those projects and continue their viability.

We are continually receiving offers by other companies to sell us additional properties. Upon examination, we find most of these projects need significant expenditures for repair, for major repairs or replacements. We fear that unless we or others like us can acquire those units, they will fall into a state of significant disrepair and ultimately become urban slums. Without some ownership incentive, there will be no continued investment of funds to keep those projects operating.

There is no cash-flow available in low- and moderate-income housing. Our experience with 500 projects supports that. There is virtually no appreciation. Only tax assistance can provide an economic incentive to keep those projects in being.

As we examine H.R. 3838 and its impact on the existing stock of housing, we become very fearful. The incentives that led to the construction of housing were also used to preserve the existing stock. We worked diligently before the House to try to preserve some benefits for low- and moderate-income housing, mainly with respect to existing housing, but our efforts in the House have been rendered almost totally fruitless, because of the alternative minimum tax.

We fear that if the alternative minimum tax is retained in its present form, without exemption or preferences for low- and moderate-income housing, there will be no significant private sector funds flowing into the preservation of the existing stock of housing. We urge this committee to make its views known to the Senate Finance Committee and otherwise to ensure that the tax bill is revised to provide relief for low- and moderate-income ownership tenants from the alternative minimum tax.

We're not making any significant additional proposals. Instead we prefer to work closely with this committee, the staffs, and the Senate Finance Committee to try to help fashion a bill which more closely meets the needs of low- and moderate-income tenants. Thank you.

[The complete prepared statement follows:]

STATEMENT
BY
J. RODERICK HELLER, III
PRESIDENT
NATIONAL CORPORATION FOR HOUSING PARTNERSHIPS
BEFORE THE SENATE COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS
FEBRUARY 6, 1986
CONCERNING THE
IMPACT OF H.R. 3838 ON RENTAL HOUSING

I am delighted to appear before the Committee on behalf of National Corporation for Housing Partnerships. NCHP is unique, a private entity created by Congress in 1968 with the stated purpose of encouraging the maximum participation by private industry in programs and projects to provide low and moderate income housing.

NCHP

- Is the largest owner and operator of low and moderate income multifamily rental housing in the country, with 80,000 units;
- Is the largest manager of low and moderate income rental housing, managing 50,000 units;
- Has never returned a single mortgage to HUD-an accomplishment requiring not only dedication and hard work but millions of dollars of loans to projects; and
- Operates on a national scale with approximately 500 rental properties located in 39 states, the District of Columbia and Puerto Rico.

Members of this Committee may be interested to know that NCHP has 257 properties in 14 of the 15 states which members of this Committee represent.

NCHP was initially capitalized with $42 million contributed by 268 industrial corporations, financial institutions, labor unions and other entities. The organization of NCHP was premised on the continuation of federal housing and tax policies. In response to the "national goal of a decent home and a suitable living environment for every American family", which President Johnson's Committee on Urban Housing established, Congress provided for many years a variety of programs to subsidize the construction of low and moderate income housing, of which the best known were the so-called "Section 236" and "Section 8" Programs. Similarly, the Internal Revenue Code of 1954, as amended in the late 1960's, encouraged private investment in low and moderate income housing by permitting investors to obtain significant tax benefits through investment in such housing, a sector of the economy which otherwise could not attract investment capital.

Of NCHP's properties, 64% were newly constructed under various state and federal programs, and 17% were rehabilitated with the benefit of either the rehabilitation or historic tax credits. The remainder of NCHP's properties were purchased from the original property owners after many years of operation - so-called "existing" properties.

This paper is not presented on behalf of NCHP's business interests. NCHP is now strong and flexible enough to adjust to adverse changes in the tax laws. But its constituency-the low and moderate income families living in each of your states - is not. When I speak of NCHP's constituency, I speak not only of the inner city poor, although that group ought to remain important in the national conscience. I speak of low income families living in NCHP properties in small cities and rural areas all across the country. I speak of the elderly who are served by 94 of our senior citizen projects in 26 states. I speak of young people ages 20 to 30, whose net after tax income has fallen by nearly 14% in the last 10 years.

II.

Construction and Preservation of Housing

The need to construct affordable housing for our low and moderate income citizens is well documented. A recent Brookings Institution study conservatively estimated that an additional 2.3 million units of low and moderate income housing will be required over the next 15 years.

Of equal importance is the need to preserve the nearly 4.0 million units of HUD and FMHA assisted rental housing, that, like all housing, needs periodic infusions of capital for repairs and rehabilitation. Since 1968 Congress consciously has made a tremendous investment in shelter for the economically disadvantaged. It is essential that this Congress ensure that the investment represented by housing now under federal subsidy not be allowed to deteriorate. There are no policies -- and to our knowledge, few serious studies -- aimed at ensuring that existing housing is preserved for low and moderate income renters.

There are approximately 440,000 units of Section 236 and approximately 154,000 units of Section 221(d)(3) below market interest rate projects in private hands. These projects are generally 10-15 years old and confronting major capital repairs. The nearly 2 million units assisted under the

Section 8 program, the successor to the Section 236 and Section 221(d)(3) programs, will need the same sort of repair and rehabilitation. Moreover, a high percentage of Section 8 projects are under 15 year contracts that will begin to expire in 1991. Most of these federally-assisted units have enjoyed only marginal cash flow. Almost all will require repairs: an industry study in 1983 revealed that approximately 10% of the inventory had an immediate average need of $800 per unit for repairs and replacements.

Our own experience in purchasing older projects suggests a required expenditure of between $700 and $1200 per unit. Beginning in 1982, we acquired 95 properties which were originally completed 10 to 15 years before. As part of this acquisition program, it was necessary to invest almost $8.5 million to preserve and upgrade units, thereby avoiding further deterioration. One of NCHP's goals is to purchase more such properties. It is our view that ownership of existing government-assisted property by entities such as NCHP should be encouraged if we are to prevent the nation's existing housing stock from deteriorating in the hands of owners who either no longer have the financial ability or the long-term management capability necessary to operate such housing. As we suggest below, several changes to H.R. 3838 and the Tax Reform Act of 1984 will be necessary to permit such sales.

Despite the apparent rental housing need, the budget crisis has caused a radical reduction in the budget authority needed to embark into new construction or to extend existing subsidy contracts. For fiscal year 1981, Congress appropriated $30 billion of budget authority for assisted housing programs. For fiscal year 1986, Congress appropriated $9.9 billion, and the Administration seeks to rescind all but $3.9 billion.

III.

Attracting Capital to Rental Housing

It is NCHP's premise that substantial additional capital must be attracted if America is to build needed additional low and moderate income rental stock and to preserve units. It is axiomatic that capital can be attracted only in response to one or more of three incentives: current cash flow, appreciation, and tax benefits.

It is a fact that NCHP has been able to compete with other investment alternatives solely because the tax laws enabled it to provide competitive returns. Land prices, construction and financing costs, and operating expenses are so high today that rents even from moderate income families cannot provide sufficiently attractive rates of return for investors. In federally-assisted and state agency financed projects distributions are limited by law, if there is cash flow at all. NCHP's experience in over 500 projects suggests that cash returns in most projects will be minimal. Similarly, provisions restricting the use of such property to housing for low and moderate income families means that appreciation in value is a hope rather than a realistic expectation. In any case, budget pressures have essentially eliminated most program funding.

The principal features of the present tax code that have enabled us to attract equity capital for low and moderate income rental housing are depreciation on a 15 year, 200% declining balance schedule; the full deductibility of interest expense; the full deduction of construction period expenses and the ability to include non-recourse financing in the basis of real estate. Together, these provisions have enabled us to develop nearly 80,000 housing units by raising nearly $500 million through limited partnerships for low and moderate income housing despite the constraints on cash flow and appreciation.

On the debt side, the availability of tax-exempt financing for projects in which 20% of the units are set aside for low and moderate income residents has materially contributed to the production and rehabilitation of rental housing. NCHP has developed approximately 11,000 units of low and moderate income housing using the proceeds of tax exempt bonds.

I am not here today to represent that our present tax code is the most equitable and efficient way to preserve and expand affordable housing for low and moderate income Americans. Let me be blunt. It is not the most attractive feature of the present tax landscape that real estate investments help enable some taxpayers to reduce their tax liability to near zero. And dollar for dollar, direct subsidies are probably more efficient in creating the economics that will attract capital. Our discomfort with these facts, however, cannot end the analysis. If the tax code has become our housing policy, we must ask what that policy is and what it should be. First and foremost it is a policy of favoring homeowners over renters. The Joint Committee on Taxation has estimated that of the total of $43.6 billion of housing-related tax expenditures in 1984, $39.4 billion, or 90%, went to homeowner deductions and only $4.3 billion went to rental properties. Yet one-third of America's households rent, and the median income of renters in 1981 was $11,400 compared with $21,000 for homeowners.

We do not need to review for this Committee the studies by the Joint Center for Housing Studies at MIT and other authorities which demonstrate that any serious effort to provide new or rehabilitated housing for low and moderate income households or to preserve existing housing stock requires extensive Federal assistance either through direct assistance programs or through tax incentives. The fact is that the budgetary constraints are causing cutbacks in direct housing program assistance. If both the government and the private sector retreat from the task of providing decent affordable low income housing we will as a nation be turning our back on a critical social objective just at the time when the hardship of such neglect will be reaching its peak.

IV

H.R. 3838's Impact on Rental Housing

In partial recognition of the need to retain incentives for low income housing the "tax reform" bill (H.R. 3838) passed by the House in December preserves some benefits for low and moderate income rental housing while severely limiting incentives for investment in market rate rental housing. The House bill, for example, eliminates the current tax code distinctions between rental housing and commercial real estate requiring investments in both to depreciate on a straight-line basis over 30 years (compared with 19 year, 175 declining balance for rental housing under current law). It also requires construction period interest and taxes to be capitalized and depreciated rather than amortized over 10 years. But H.R. 3838 does allow for more favorable depreciation for low income housing compared with market rate housing. And it would allow continuation of IDB financing, although with stricter targeting and state-by-state volume caps.

On the whole, however, even for low and moderate income housing, H.R. 3838 will sharply curtail new construction and accelerate the erosion of existing housing stock:

--construction period interest and taxes, currently expensed immediately for low income housing, will now have to be depreciated over a period of 20 or 30 years, depending on the low-income category (20% of the tenants below 70% of median income, 25%/80% or 40%/60%) the project falls in.

--when you take the new treatment of construction period interest and taxes into account, the new depreciation schedule for all categories of low income housing would be less favorable than current law depreciation of low-income housing.

--the additional incentive of 20 year double declining balance depreciation for very low income housing (40% of tenants below 60% of median income) will probably not be enough to encourage investment without additional incentives.

--for the upper tier of low income housing defined by H.R. 3838 (20% of tenants below 70% of median income or 25% below 80% of median income), the pace of new construction will vary from region to region, depending on whether market rate rents rise far enough to justify new market-rate rental housing investments.

--decisions to invest in low income housing will be adversely affected across the board by the impact of the new alternative minimum tax which includes a variety of allowable expenses in housing investments--such as accelerated depreciation and rapid amortization of rehab expenses--as preference items to be added back and taxed at the minimum tax rate.

While curtailment of tax incentives for investment in rental housing will eventually cause higher rents for renters, the impact will be more sudden and severe for low and moderate income households. Relatively high vacancy rates for high-rent units will cushion the shock for this part of the market but supply of low-rent units is already very tight in many areas. There will be no cushion for low income renters, who already pay a far larger percentage of income for housing than the general population.

V

Proposals

We believe that three issues are of paramount importance: the effective dates of new legislation, the application of the minimum tax and the preservation of seller-financing for sales of existing projects.

Effective dates

The first issue which we urge the Committee to address is the chilling effect uncertainty about tax changes is having on the start of new multifamily housing projects for low and moderate income renters. We are faced at this time with a virtual halt in the development of such housing because of the January 1, 1986 effective date for certain changes in the tax code contained in H.R. 3838.

We are aware of the resolutions of both the House and Senate to the effect that this effective date be postponed until January 1, 1987. We recognize that the staff of the Senate Finance Committee on January 25 acknowledged concern about the adverse effects on the economy and the unreasonableness of expecting taxpayers to comply with major changes in the tax law before they are enacted. The staff recommended that Chairmen Packwood and Rostenkowski jointly announce their intent to push effective dates ahead to January 1, 1987 or the date of Presidential signing of the bill.

While these statements are a strong indication of Congressional intent, they do not have the specificity needed for counsel to provide the legal opinions necessary to give investors the confidence they need to proceed with new investments. The attached letter from NCHP and other groups in support of rental housing for low and moderate income renters spell out in detail the sections of H.R. 3838 which need to be addressed in transitional language.

We are particularly concerned that the September 25, 1985 binding contract date in H.R. 3838 be extended so that planning for low and moderate income projects can continue even if those projects cannot be placed in service by January 1, 1987. We recommend a one year extension of the House date to September 25, 1986 or the date of enactment, whichever is later.

Minimum Tax

The House bill includes a new minimum tax provision which, which will cripple the syndication market for low and moderate income housing. By limiting excludable business losses to $50,000, H.R. 3838 virtually destroys incentives for high-income taxpayers to invest in low income housing partnerships. This minimum tax provision has a "now you see it, now you don't" effect on the tax preferences for low income housing included elsewhere in the bill. Unless H.R. 3838's minimum tax is modified to provide some exceptions for investment in low-income housing, the accelerated depreciation, tax-exempt bond financing, "at risk", business interest exceptions, and other low income benefits are meaningless.

It is important to note that H.R. 3838's minimum tax is retroactive. Its $50,000 ceiling on excludable business losses applies to losses from past as well as future investments. In addition, H.R. 3838 reintroduces through the back door the "at-risk" rule for qualifying low income properties by restricting losses excludable under the minimum tax to the actual cash investment in the property.

We are in agreement with the principle which underlies the concept of the minimum tax. Ideally every taxpayer should pay some tax, unless, as a matter of national policy, Congress decides that other national commitments -- such as decent, affordable housing for low income people -- take precedence. From our experience in seeking investment for our low and moderate income housing projects, we have no choice but to advise the Committee that some modification of the alternative minimum tax is essential if we are to compete successfully in the financial marketplace for capital for low-income projects. We recognize that exceptions from the minimum tax for low and moderate income housing may be politically feasible only if accompanied by other changes in H.R. 3838 to ensure greater direct benefits to low income households. We look forward to discussing with the Committee our ideas as what form these changes may take.

Seller Financing

The 1984 Tax Reform Act required buyers and sellers to "match" the treatment of interest deductions on seller-financed notes, taken back in the course of a sale of a low income housing project which do not make current interest payments. This law effectively prevents future sales of low and moderate income apartments to new owners because the limited cash flow on such housing does not permit the servicing of additional debt - and sellers will not put themselves in a situation of recognizing income without cash to pay the tax.

H.R. 3838 only exempts third party financing from the "at-risk" rules. We believe a similar exemption must be extended to seller-financed low and moderate income rental housing.

Conclusion

The Congress and the Administration have already substantially affected the cost and availability of low and moderate income rental housing by decisions on funding for housing programs. The House has, perhaps inadvertantly, crippled incentives for a private sector response to the crisis through its contradictory action on H.R. 3838. With Congress and the Administration in the throes of the current budget crisis, we do not expect programmatic relief in the Senate. We do hope and expect that the Senate Finance Committee and ultimately the full Senate, enlightened and informed by this Committee, will turn aside the confusion of H.R. 3838 and preserve the tax preferences for low and moderate income rental housing in current law.

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December 23, 1985

Gentlemen:

The undersigned groups are most concerned about providing rental housing for low and moderate income Americans.

We are faced at this time with a halt in the development of such housing because of the January 1, 1986 effective date of certain changes contained in HR 3838, the Tax Reform Act of 1985. We are aware of the resolutions of both the House and Senate to the effect that this effective date be postponed until January 1, 1987 because of the adverse effects on the economy and the unreasonableness of expecting taxpayers to comply with fundamental changes in the tax law before they are enacted. Although these statements project a strong indication of Congressional intent, they do not have the specificity required to enable counsel to provide necessary legal opinions that proposed 1986 activities will continue to be governed by present law, or for investors to feel confident about the rules which will affect their investments.

Accordingly, we respectfully request that either in the agreed statement referred to in House Resolution 335, or in some other appropriate manner, the Chairman and Ranking Member of the House Committee on Ways and Means and the Senate Committee on Finance indicate that the effective date for the following changes affecting low and moderate income housing be no earlier than January 1, 1987:

a. Changes in the depreciation recovery period set forth in Title II of the Bill;

b. Changes concerning the deductibility of business interest by limited partners as set forth in Title IV (the House bill would exempt only some low income housing projects from this provision);

c. Those provisions in Title VII changing the rules for issuance of bonds to finance multifamily rental housing;

d. Those provisions in Title V regarding the Alternative Minimum Tax.

e. Concerning the Alternative Minimum Tax, any statement should make clear that losses from limited partnerships entered into by a taxpayer before January 1, 1987, should not be subject to the Alternative Minimum Tax if they are not subject to such tax under present law. Otherwise, existing investments in limited partnerships would be retroactively affected, a most unfair result.

Finally, the September 25, 1985 binding contract date in the House bill should be extended. Many low and moderate income projects which do not meet this binding contract date may not be able to be placed in service by January 1, 1987 and therefore, simply extending that effective date may not benefit such projects. Although under the principle of extending dates one year, the binding contract date should be extended to September 25, 1986, we think that extending the binding contract date to date of enactment of the final tax reform legislation would be a more realistic alternative.

Thank you for your consideration of this matter.

Association of Local Housing Finance Agencies
Coalition for Low and Moderate Income Housing
Council for Rural Housing and Development
National Corporation for Housing Partnerships
National Leased Housing Association
National Low Income Housing Coalition

The Honorable Bob Packwood
Chairman, Committee on Finance
219 Senate Dirksen Office Building
Washington, D. C. 20510

The Honorable Russell B. Long
Ranking Minority Member
Committee on Finance
225 Senate Russell Office Building
Washington, D. C. 20510

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
1102 Longworth House Office Building
Washington, D. C. 20515

The Honorable John J. Duncan
Ranking Minority Member
Committee on Ways and Means
1106 Longworth House Office Building
Washington, D. C. 20515

The Honorable James A. Baker, III
Secretary
Department of the Treasury
15th Street and Pennsylvania Avenue, N.W.
Washington, D. C. 20220

The CHAIRMAN. Thank you, Mr. Heller. Mr. Zigas.

STATEMENT OF BARRY ZIGAS, PRESIDENT, NATIONAL LOW INCOME HOUSING COALITION

Mr. ZIGAS. Thank you, Mr. Chairman. My name is Barry Zigas, and I'm president of the National Low Income Housing Coalition. I appreciate the opportunity to appear before you today on this important matter.

I want to be brief as well. A lot of the prior witnesses have covered areas that my written statement covers. I would like to submit the written statement with its attachments for the record.

The CHAIRMAN. It will be included in full.

Mr. ZIGAS. Thank you. I'd like to summarize, if I might, some of the major issues we have about this.

First I would like to emphasize, as this committee knows, that low-income Americans are facing an unprecedented housing crisis. We can see this in the streets of American cities with homelessness. We see it in increased rents. And I urge you to pay some close attention to the Housing Crisis Index that we have provided as an attachment to our statement. It shows you in graphic detail, using census data, how much worse the problem is for low-income renters in 1985 then it was in 1980.

The question confronting this committee and the Finance Committee, as it addresses H.R. 3838, is what role tax policy ought to play in addressing this crisis.

MORE DIRECT SPENDING

As you know from previous appearances here by both my predecessor and myself, the National Low Income Housing Coalition has for many years advocated more emphasis on direct spending and less emphasis on indirect spending.

Overwhelmingly, the tax subsidies provide benefits to high-income taxpayers and not to low-income renters. However, we are here today, because as you well know, direct assistance for low-income housing programs and policies has been greatly reduced and deeply cut. Budget cuts in the past have reduced almost all funding for new construction and development and preservation and the President's proposals released yesterday would go even further than current law.

The Tax Code is the only means by which to preserve, as Mr. Heller has so eloquently stated, and to develop additional supplies of low-income housing. It is not an efficient means of doing it. We wish there was a better means, but at the moment it is the only means available to us.

H.R. 3838, I want to add, is vastly different and in many ways much better—almost in all ways, much better than the original proposal of President Reagan on tax reform, and there are some good provisions in the real estate sections that we believe ought to be maintained.

The use restrictions on low-income advantaged properties, which were greatly extended in the bill, ought to be extended, not totally as provided in the bill, but certainly to at least 15 years. That is a provision that deserves attention. The annual recertification of income of tenants in qualifying units ought to be retained. That is an important improvement. And the adjustment for family size and the income limits for the qualifying low-income units is an important reform that deserves to be maintained.

There is much, however, that is left to be desired in this bill. There are, for instance, no rent restrictions in the new bill or in the current code applying to the units that are provided for low-income tenants, despite the longstanding principle this committee has enforced in direct Federal subsidies to require such restriction.

No. 2, there is no prohibition in current law or H.R. 3838 against the use of IDB financing in instances where low- and very low-income tenants in existing properties will be displaced through the action of public financing. We believe that is a scandal. We don't believe these funds should be permitted to be used to aggravate the low-income housing crisis. We urge you to recommend such a prohibition to the Finance Committee, as we will.

There is only minimal improvement in the targeting of the vast majority of the benefits that this program of tax advantages will provide, and we feel that much greater targeting can be achieved.

We have included in our remarks for the record, some proposals that we urge your attention to in that regard.

As Mr. Heller has said, the protections for the existing stock of low-income housing which is so valuable, particularly in light of Federal cutbacks in recent years, are completely inadequate and need to be overhauled. We also have made concrete proposals for how to do that in our statement, and I urge your attention to that.

Let me finish by saying that the question of highly targeted tax-based subsidies should not be a matter of debate. We have, in the last 5 years and before that, as well, come to your committee. We have heard many cogent arguments for the need to highly target direct funding assistance. Some arguments apply equally well to tax subsidies. What we find in the multifamily tax advantage areas is minimal tax losses. We find a really low degree of targeting, which we believe can be extensively improved.

The losses in revenue that our proposals attached to our statement would incur would probably be no more and almost certainly a great deal less than the deductions H.R. 3838 preserves for vacation homes. It would certainly be a great deal less than H.R. 3838 provides for tax advantaged investments in owner-occupied housing.

I urge this committee to assist in whatever way it can to first urge the Finance Committee to retain what is good about H.R. 3838, to fix what is bad and to urge them not simply to try to fix up amendments to accommodate little problems that H.R. 3838 has provided for, but to undertake the substantial revision that would greatly increase the targeting benefits this program provides.

Thank you very much, and I'll be happy to answer any questions.

[The complete prepared statement follows:]

National
Low Income Housing Coalition
1012 Fourteenth Street, N.W., Suite 1006, Washington, D.C. 20005 • (202) 662-1530

Hon. Edward W. Brooke, *Honorary Chairperson*
Barry Zigas, *President*

PREPARED STATEMENT OF

BARRY ZIGAS, PRESIDENT

ON THE
IMPACTS OF H.R. 3838 ON LOW INCOME HOUSING

BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
U.S. SENATE

FEBRUARY 6, 1986

Mr. Chairman, distinguished members of the Committee, my name is Barry Zigas. I appear before you today as President of the National Low Income Housing Coalition. NLIHC is a national, nonprofit, nonpartisan organization representing individuals and organizations throughout the Nation. We provide advocacy services for these members to pursue policies at the federal level to end the low income housing crisis.

My testimony will address three broad areas:

1. the extent of the low income housing crisis and the federal government's current role in helping to end it;

2. the role which tax policy plays in federal housing policy, especially for low income people; and

3. specific comments on H.R. 3838.

The Low Income Housing Crisis

Mr. Chairman, low income people face a severe housing crisis. The shortage of affordable housing--either for rent or for home-ownership--has driven thousands of families into the streets, into overcrowded housing, into desperation. The growing cancer of homelessness in cities throughout the country is a grim and potent reminder of how difficult it has become for so many thousands of people to put a roof over their heads.

Even for those who are fortunate enough to find shelter, the cost of a home can be frighteningly high. Analysis of the American Housing Survey by the Low Income Housing Information Service, an affiliated organization of NLIHC, shows that the vast majority of very low income households is paying exorbitant amounts for shelter. According to the 1983 AHS, over 8.4 million renter households earned less than $7,000 per year. These are the lowest income renters in the country, with incomes no greater than 50 percent of renter median, about 30 percent of national median, and less than 25 percent of owner median. **Yet among this group, about 90 percent paid more than 25 percent of their income for rent. About 80 percent paid more than 35 percent, and over half paid more than half their income for rent.**

President Reagan's Commission on Housing estimated in 1981 that over 7.5 million very low income renter households were eligible for federal rental housing assistance but unable to receive it because of program limitations.

Another recent analysis by LIHIS shows how desperate this situation has become for millions of low income renters. While there were over 8 million renter households with incomes below 50 percent of renter median in 1985, less than 4 million units of housing affordable to those renters at 30 percent or less of this income level were available in the market. **Nearly twice as many very low income renters are seeking affordable rental housing** than can be found in the market. A comparative analysis with similar figures from 1980 shows that the gulf between demand and supply of low income housing has widened substantially over the last five years. With your permission, Mr. Chairman, I would like to submit this analysis, called the **Rental Crisis Index**, as part of the record of this hearing.

The Federal Response

In the last five years, the federal government has beat an unprecedented retreat from its traditional policy of broad support for the needs of low income renters. This Committee and the Congress as a whole has agreed to massive reductions in budget authority for assisted housing programs. Over 60 percent of the budget authority made available in 1981 has been slashed from subsequent budgets. New construction and substantial rehabilitation programs have been all but eliminated. The remaining assistance through Section 8 Certificates and the Administration's voucher demonstration has been slashed deeply, providing only a token level of assistance for low income renters.

These cuts have been made in the name of budget deficit reduction. Yet over the same period of time that Congress and the Administration were asking low income families to forego decent, affordable housing, the budget deficit more than tripled to its current levels.

This year, with the pressure of the Gramm-Rudman-Hollings budget legislation, the Administration will seek deferrals and rescissions of even the modest funds approved in FY86. The future promises little in additional assistance for low income renters. In fact, the Senate last year only narrowly rejected a proposal to eliminate funding for assisted housing altogether during debate on the HUD appropriation. The support this amendment received from members of this Committee from both sides of the aisle is a sad comment on Congress' commitment to continuing a 50-year bipartisan effort to improve housing conditions for all Americans.

While the federal government has been busy sacrificing low income rental housing assistance on the altar of budget deficit reduction, it has been more generous to wealthy Americans. Out of a total expenditure last year of around $50 billion for housing assistance, low income people received about $10 billion through outlays in HUD's budget. Over $35 billion of the remainder was expended on wealthy homeowners through tax subsidies for mortgage interest, property taxes, and other special treatment. Not only were these subsidies left intact, but the President's budget for FY86 estimated a nearly 10 percent **increase** in such subsidies last year.

Only about $3 to $4 billion of this total was expended on investor incentives for multifamily rental housing development. Analyses published by the Joint Committee on Taxation suggest that investor deductions--those most directly addressed by H.R. 3838--will comprise only about 13 percent of all housing tax expenditures through FY90 under current law.

Mr. Chairman, the inequity of federal housing policy is manifest. Maintenance of costly and inefficient tax subsidies which primarily benefit wealthy people and encourage the overconsumption of secondary as well as principal residences at the expense of direct subsidies for the poor is a scandal. Yet as the members of this Committee can attest better than most, Congress' will to restore equity to the system through increased authorizations for direct low income housing assistance is weak.

Tax Reform in H.R. 3838

It is in this context of inequity, unfairness and abandonment of a compassionate and highly targeted national housing policy that I appear today to urge this Committee to help us protect and improve the costly, inefficient tax-based subsidies which encourage low income housing development. I do so reluctantly and with considerable distaste. The National Low Income Housing Coalition has long deplored the use of such inefficient subsidies to accomplish national objectives. We have implored this Committee to increase direct spending so that such indirect and inefficient tax subsidies could be eliminated or curbed. But Congress has placed us in an unenviable position. It has taken away most of the progressive and targeted assistance. It has forced us to seek the preservation of subsidies which increase the cost of subsidy to the taxpayer, and reduce the benefit to low income households.

The provisions of H.R. 3838 must be changed to preserve the only substantial source of federal housing assistance for the preservation and development of affordable rental housing. This Committee must play a major role in educating the members of the Senate Finance Committee in the role these tax subsidies play in fostering such development. And this Committee can and should play a major role in helping the Finance Committee to amend the provisions of H.R. 3838 to increase the degree of targeting required to receive these tax subsidies.

Our concerns with H.R. 3838 address the following issues:

1. The inadequate degree of targeting required to qualify projects for advantageous tax treatment.
2. The lack of any restrictions on the amount of rent which may be charged low income tenants in units qualifying as low income.
3. The lack of any prohibitions against the use of tax

exempt bonds to finance displacement of low and very low income tenants through acquisition and rehabilitation of existing, already occupied low income rental housing.

4. The unrealistic depreciation schedules applied to rental housing, particularly rental housing serving a high proportion of low income tenants.

5. The lack of special tax treatment to foster the preservation of thousands of units of federally-insured existing low income rental projects occupied primarily by those with incomes below 80 percent of median.

6. The imposition of unrealistic caps on IDB housing bond issuances.

7. The inclusion of income and losses from low income housing partnerships in calculation of the alternative minimum tax.

8. The exclusion of certain otherwise qualified low income properties from exemption from the business interest cap.

Constructive Proposals

I have attached a summary of our specific concerns with H.R. 3838 to this testimony. I request that it be included as part of my prepared statement. I would like here to outline some constructive proposals which the National Low Income Housing Coalition is proposing to the Senate Finance Committee. These proposals were developed with the cooperation of an informal group of representatives from nonprofit development and advocacy organizations in Washington and elsewhere.

Replace the deduction provisions of H.R. 3838 with a tax credit

Using deductions to provide tax subsidies for qualified multifamily developments is inherently wasteful. Knowledgeable experts have estimated that 3 out of every 4 dollars in federal tax subsidy flows not to low income beneficiaries but to high income taxpayers or intermediaries through transaction costs. Converting this system to one of tax credits would greatly reduce the cost of these subsidies, increase their targeting to low income housing consumers, and simplify administration of the Code. The credits could be either refundable or non-refundable. If the former, they would provide nonprofit sponsors an especially effective source of development capital and greatly reduce the need to market projects to tax shelter oriented investors. If non-refundable, the credit approach could still greatly streamline the subsidy mechanism and increase the benefit of the tax subsidy to the consumer. We are continuing to work on this alternative to develop a complete proposal. I hope we can share this with the Committee as it is developed.

Provide for rent restrictions in targeted units

Neither current law nor H.R. 3838 mandates any limit on the rents which may be charged tenants in qualifying low income set-aside units. Thus, although assistance through tax subsidies is premised on the assumption that low income tenants will benefit from lower rents, there is no limitation on what those rents can actually be, except for what the market is willing to bear. An analysis of GAO's investigation last year of 7,500 IDB financed units shows that the average low income tenant in a set-aside unit is paying 29 percent of income. Tenants in non-qualifying units, on the other hand, were paying about 16 percent of income for rent. Clearly some qualifying tenants are paying more than 29 percent of income for these units--some may be paying a great deal more. Meanwhile, tenants in non-qualifying units are benefitting from a very substantial reduction in rent burden, compared with the 29 percent of median we estimate current median rents to be.

The principle of rent limitations in federally assisted low income properties is well-established in direct federal programs. I urge you to recommend that a similar limitation be imposed on projects which are receiving indirect, tax based subsidies, as well.

Anti-Displacement Guarantees

Neither H.R. 3838 nor the current Code contain any restrictions against the use of IDB financing to carry out acquisition and development which will lead to displacement of existing low or very low income tenants. Yet Legal Services attorneys and other local advocates report that a substantial portion of their displacement case load is the direct result of such IDB financed projects. The Senate tax bill should include a prohibition against using IDB financing in the acquisition, rehabilitation or new construction of any housing where low or very low income persons will be displaced by those of higher income. At the very least, we should insure that these tax subsidies are not used to aggravate the low income housing crisis.

Increased targeting requirements

H.R. 3838 provides some modest increase in targeting for the bulk of the projects which will be financed through tax subsidies. It also creates a new class of properties in which 40 percent of the units would be occupied by tenants with 60 percent or less of area median. This group would be eligible for 20 year, 200 percent depreciation. While this new category promises development for very low income tenants, it delivers an insufficient amount of subsidy to provide it without substantial amounts of additional subsidies from state or local governments or corporate and philanthropic contributions.

In lieu of this multi-layered approach, the National Low Income Housing Coalition proposes a single, more highly targeted program. This program would establish a single qualifying threshold--at least 20 percent of the units occupied by households at or below 80 percent of median, and an additional 10 percent at or below 50 percent of median. Reaching this threshold would assure the project of IDB eligibility and a 20-year, 200 percent depreciation schedule. Any project which exceeded these minimum thresholds would receive the same 5 year, 100 percent depreciation treatment that is available under Section 167(k) on a unit-by-unit basis for those projects which are occupied by tenants with incomes below 80 percent of median.

This single definition would restore a high degree of targeting to the Code's rental housing provisions. I assure you that this mix creates an economic product in most markets. In those where it does not, projects can seek additional subsidies, just as those which H.R. 3838 would create in the very low income category would have to. The difference is that this qualifying category would apply to the great majority of units likely to receive tax subsidies--those financed through IDBs by profit-motivated sponsors.

Protecting the Existing Stock of Low Income Housing

There are today thousands of units of previously subsidized and insured low income housing which H.R. 3838 will jeopardize. These properties are reaching the end of the recapture period for tax benefits under the current Code. Their owners are approaching a time when their primary concern will be to recover their investments from these properties after over 18 years. They are predominantly occupied by low income tenants, and represent an irreplaceable resource we cannot afford to lose.

H.R. 3838 will very likely accelerate the sale and conversion of these properties. At the very least, it will encourage their conversion from principally serving low income households to serving a market-based mix of tenants who can pay economic rents. Current low income tenants will not be eligible for any continuing federal assistance. They will not even qualify for relocation expenses if they are forced to move.

We propose establishing a new category of housing under the Code--Predominantly Low Income Housing (PLIH). This housing would be defined as that in which at least 80 percent of the units are occupied by tenants with 80 percent or less of median income. Rents in these projects must be limited to no more than 30 percent of 80 percent of median for qualifying households. PLIH projects would be eligible to receive 10 year, 200 percent depreciation. Current recapture provisions--no conversion to other use during the first ten years without complete recapture of tax subsidies taken, with a phase out over the next 10 years--would apply. In addition, if the property is sold or transferred after the first ten years, and the low income use is maintained, no penalty would apply. Properties which are otherwise eligible for Historic Tax Credits which qualify as PLIH would be able to enjoy the full appropriate credit. Again, use would have to be maintained for at least 10 years or stiff penalties would apply.

For properties in which rehabilitation was undertaken, Section 167(k) rules would apply as in H.R. 3838. However, if the property is sold within a reasonable time period to a qualified low income cooperative, it would qualify for a maximum $40,000 per unit rehab cost, rather than the $30,000 applied in H.R. 3838.

PLIH properties would be exempt from the at-risk rules, and H.R. 3838 would have to be amended in Section 401 to expand the at-risk exemption so that qualified nonrecourse financing would include such financing that "is used to acquire interests in property which is used and will be maintained as PLIH."

PLIH properties would be exempt from the limitation on nonbusiness interest deductions, and PLIH properties would qualify for special, favorable treatment under the alternative minimum tax.

Finally, we propose to include PLIH as an "essential governmental purpose" under the tax-exempt bond definitions. This would place such financing for qualified PLIH properties outside of the caps established for non-governmental bonds in H.R. 3838. We oppose the cap generally. But if Congress must impose one, we believe PLIH should be exempted. The vast majority of projects qualifying under PLIH will be existing properties. They cannot and will not compete effectively with new construction of multifamily or single family homes under a state-by-state cap. Moreover, we believe that the preservation of existing low income housing is an essential governmental function, and the Code should recognize this.

SUMMARY

Mr. Chairman, the tax Code is a blunt instrument when it comes to social policy. As I stated earlier, we would much prefer to see federal resources made available directly for low income housing development and preservation. But we have no reasonable expectation that Congress will reverse course this year or any time soon and increase its direct appropriations for low income housing assistance. In the meantime, the Nation faces an urgent housing crisis. Thousands of units of housing already subsidized by HUD face conversion to market rates in the next five years unless special tax treatment is extended to them. In general, the only production or preservation of affordable housing throughout the country is being undertaken by state and local agencies using tax-exempt bonds and other tax-based subsidies to attract equity investors. An entire nonprofit housing development sector has arisen since 1981 to try to fill the gap left by HUD in its retreat from development. Your Committee should have a strong interest in seeing that the Senate Finance Committee's version of tax revision provides the most highly targeted, feasible system of tax subsidies possible. I believe our proposals are a step in that direction, and I urge you and your colleagues to support them.

Thank you again for the opportunity to share our views with you on this important matter. I will be happy to answer any questions you may have.

National
Low Income Housing Coalition
1012 Fourteenth Street, N.W., Suite 1006, Washington, D.C. 20005 • (202) 662-1530

Hon. Edward W. Brooke, Honorary Chairperson *Barry Zigas, President*

RENTAL HOUSING CRISIS INDEX

The Rental Housing Crisis Index is a means of determining housing needs. It is the number of very low income renter households divided by the number of existing affordable rental units. Thus, the higher the index, the worse the problem. Any Index greater than 1.00 indicates more households in need of affordable housing than there are rental units available in the state.

The tables presented are based on 1980 census data, trended forward to get estimates for 1985. There are two tables for 1980 and two for 1985. The tables list the states alphabetically and by degree of severity. For each state the tables show the following information:

. THE NUMBER OF RENTER HOUSEHOLDS EARNING 50% OR LESS OF MEDIAN RENTER INCOME FOR THE STATE.

. AN AFFORDABLE MONTHLY RENT AT 30 PERCENT OF THIS INCOME LEVEL.

. THE NUMBER OF RENTAL UNITS BY STATE WHICH CAN BE RENTED AT THIS AFFORDABLE RENT.

. THE GAP BETWEEN THE RENTER HOUSEHOLDS WITH INCOMES BELOW 50 PERCENT OF THE RENTER MEDIAN INCOME, AND THE NUMBER OF UNITS RENTING AT THIS AFFORDABLE RATE.

PLEASE NOTE: This analysis is a conservative estimate of the unmet affordable rental housing need, since it includes all units renting at the stated level whether or not they are standard, and assumes that all are available to low income renter households, which is seldom the case.

(This information was developed by the Low Income Housing Information Service,and is derived from the 1980 Census.)

The Growing Rental Housing Crisis: 1980 Compared with 1985

Area	1980 Renter hh (50% median	1980 Afford-able rent at 30%)	1980 Afford able Units	1980 Gap or surplus	1980 Rental crisis index	1985 Renter hh (50% median	1985 Afford-able rent at 30% of income	1985 Afford able Units	1985 GAP	1985 RENTAL CRISIS INDEX	INCREASE IN GAP 1980-85
Alabama	100,155	$110	105,250	5,095	0.952	114,176	$143	88,050	(26,126)	1.297	31,221
Alaska	13,701	$219	12,881	(820)	1.064	15,619	$284	13,497	(2,122)	1.157	1,302
Arizona	75,802	$142	54,093	(21,709)	1.401	86,414	$185	45,407	(41,007)	1.903	19,299
Arkansas	60,149	$108	63,324	3,175	0.950	68,570	$141	57,205	(11,364)	1.199	14,539
California	951,121	$154	462,348	(488,773)	2.057	1,084,277	$200	294,871	(789,406)	3.677	300,634
Colorado	94,096	$146	58,236	(35,860)	1.616	107,269	$189	47,542	(59,727)	2.256	23,866
Connecticut	98,605	$157	65,902	(32,703)	1.496	112,409	$204	40,106	(72,303)	2.803	39,600
Delaware	16,001	$141	10,326	(5,675)	1.550	18,241	$183	8,155	(10,086)	2.237	4,410
Dist of Columb	40,829	$155	28,248	(12,581)	1.445	46,545	$201	14,866	(31,679)	3.131	19,098
Florida	296,768	$130	176,311	(120,457)	1.683	338,315	$170	149,544	(188,771)	2.262	68,314
Georgia	163,805	$124	159,874	(3,931)	1.025	186,738	$161	120,916	(65,822)	1.544	61,891
Hawaii	35,534	$173	34,662	(872)	1.025	40,509	$225	26,803	(13,706)	1.511	12,834
Idaho	22,680	$130	18,222	(4,458)	1.245	25,855	$169	16,331	(9,524)	1.583	5,066
Illinois	377,653	$155	260,596	(117,057)	1.449	430,524	$201	154,265	(276,260)	2.791	159,203
Indiana	136,282	$143	119,115	(17,167)	1.144	155,361	$186	97,289	(58,072)	1.597	40,905
Iowa	74,128	$142	64,023	(10,105)	1.158	84,506	$185	51,834	(32,672)	1.630	22,567
Kansas	64,952	$140	63,232	(1,720)	1.027	74,045	$182	50,207	(23,837)	1.475	22,117
Kentucky	94,622	$116	99,873	5,251	0.947	107,869	$151	81,268	(26,600)	1.327	31,852
Louisiana	121,655	$125	119,683	(1,972)	1.016	138,687	$163	95,411	(43,275)	1.454	41,303
Maine	28,701	$117	21,788	(6,913)	1.317	32,722	$152	19,041	(13,681)	1.718	6,768
Maryland	138,800	$169	102,686	(36,114)	1.352	158,231	$220	56,459	(101,772)	2.803	65,658
Massachusetts	215,728	$143	150,938	(64,790)	1.429	245,929	$185	103,919	(142,010)	2.367	77,220
Michigan	218,310	$147	139,787	(78,523)	1.562	248,874	$191	118,202	(130,671)	2.105	52,149
Minnesota	102,371	$137	77,080	(25,291)	1.328	116,703	$179	55,578	(61,125)	2.100	35,834
Mississippi	59,864	$102	64,902	5,038	0.922	68,245	$173	60,592	(7,653)	1.126	12,692
Missouri	136,150	$120	119,834	(16,316)	1.136	155,210	$169	98,461	(56,749)	1.576	40,433
Montana	22,241	$128	22,946	705	0.969	25,411	$166	19,194	(6,218)	1.324	6,923
Nebraska	45,119	$139	44,626	(493)	1.011	51,436	$181	34,229	(17,206)	1.503	16,713
Nevada	30,768	$161	14,090	(16,678)	2.184	35,076	$209	9,635	(25,441)	3.641	8,763
New Hampshire	26,163	$144	18,109	(8,054)	1.445	29,826	$188	15,108	(14,719)	1.974	6,665
New Jersey	242,119	$158	139,456	(102,663)	1.736	276,015	$206	83,711	(192,304)	3.297	89,641
New Mexico	35,225	$125	31,734	(3,491)	1.110	40,156	$163	28,343	(11,813)	1.417	8,321
New York	814,315	$145	489,565	(324,750)	1.663	928,319	$188	390,630	(537,689)	2.376	212,939
North Carolina	161,466	$125	154,105	(7,361)	1.048	184,072	$162	136,009	(48,062)	1.353	40,701
North Dakota	17,787	$111	18,153	366	0.980	20,277	$170	13,832	(6,445)	1.466	6,811
Ohio	302,702	$138	232,871	(69,831)	1.300	345,080	$186	179,494	(165,586)	1.922	95,755
Oklahoma	81,989	$127	75,987	(6,002)	1.079	93,467	$165	61,682	(31,785)	1.515	25,783
Oregon	86,410	$141	51,040	(35,370)	1.693	98,508	$184	40,850	(57,657)	2.411	22,287
Pennsylvania	317,236	$136	263,253	(53,983)	1.205	361,649	$176	208,344	(153,305)	1.736	99,322
Rhode Island	34,879	$125	26,154	(8,725)	1.334	39,762	$163	19,262	(20,500)	2.064	11,775
South Carolina	76,856	$124	81,334	4,478	0.945	87,615	$161	70,536	(17,079)	1.242	21,557
South Dakota	18,630	$113	20,421	1,791	0.912	21,238	$147	16,453	(4,786)	1.291	6,577
Tennessee	127,106	$119	126,497	(609)	1.005	144,900	$154	97,660	(47,240)	1.484	46,631
Texas	439,920	$147	376,465	(63,455)	1.169	501,509	$191	285,175	(216,333)	1.759	152,878
Utah	32,549	$142	21,810	(10,739)	1.492	37,448	$185	18,791	(18,657)	1.993	7,917
Vermont	13,941	$122	8,717	(5,224)	1.599	15,893	$159	8,142	(7,751)	1.952	2,527
Virginia	160,371	$151	115,268	(45,103)	1.391	182,822	$197	96,930	(85,892)	1.886	40,789
Washington	132,297	$146	89,814	(42,483)	1.473	150,819	$189	69,547	(81,271)	2.169	38,788
West Virginia	45,348	$121	51,041	5,693	0.888	51,696	$157	46,403	(5,293)	1.114	10,986
Wisconsin	131,224	$146	93,064	(38,160)	1.410	149,592	$190	75,921	(73,671)	1.970	35,511
Wyoming	12,743	$177	15,1[illegible]	[illegible]	0.842	14,527	$22[illegible]	9,345	(5,182)	1.555	7,572
TOTAL	7,147,916	$142	5,353,301	(1,794,615)	1.335	8,146,95[illegible]	$184	4,2[illegible]	(3,942,936)	1.937	2,148,321

Source: Estimated by Cushing Dolbeare for Low Income Housing Information Service

The Growing Rental Housing Crisis: Changes in Median Rents & Renter Income, 1980 - 1985

State	1980 Renter Households	1980 Median Renter Income	1980 Median rent	1980 Med rent as % of median rtr income	1985 Renter Households	1985 Median Renter Income	1985 Median rent	1985 Med rent as % of median rtr income
Alabama	400,619	$8,798	$235	32.1%	456,706	$11,437	$282	29.6%
Alaska	54,804	$17,491	$206	14.1%	62,477	$22,738	$552	29.1%
Arizona	303,207	$11,354	$214	22.6%	345,656	$14,760	$396	32.2%
Arkansas	240,596	$8,647	$224	31.1%	274,279	$11,241	$278	29.6%
California	3,804,482	$12,323	$368	35.8%	4,337,109	$16,020	$425	31.8%
Colorado	376,302	$11,648	$260	26.8%	429,075	$15,142	$378	30.0%
Connecticut	394,419	$12,543	$211	20.2%	449,638	$16,306	$390	28.7%
Delaware	64,004	$11,246	$255	27.2%	72,965	$14,620	$371	30.4%
Dist of Columbia	163,315	$12,383	$218	21.1%	186,179	$16,098	$336	25.0%
Florida	1,187,070	$10,434	$283	32.5%	1,352,260	$13,564	$383	33.8%
Georgia	655,220	$9,903	$224	27.1%	746,951	$12,874	$317	29.5%
Hawaii	142,136	$13,853	$257	22.3%	162,035	$18,009	$467	31.1%
Idaho	90,719	$10,393	$200	23.1%	103,420	$13,511	$327	29.0%
Illinois	1,510,612	$12,361	$246	23.9%	1,722,098	$16,069	$369	27.6%
Indiana	545,126	$11,426	$270	28.4%	621,444	$14,854	$327	26.4%
Iowa	296,512	$11,382	$251	26.5%	338,024	$14,797	$339	27.5%
Kansas	259,806	$11,193	$215	23.1%	296,179	$14,551	$327	27.0%
Kentucky	378,486	$9,283	$259	33.5%	431,474	$12,068	$297	29.5%
Louisiana	486,620	$10,005	$222	26.6%	554,747	$13,007	$321	29.6%
Maine	114,814	$9,346	$180	23.1%	130,888	$12,152	$324	32.0%
Maryland	555,198	$13,508	$266	23.6%	632,926	$17,560	$399	27.3%
Massachusetts	862,910	$11,410	$218	22.9%	983,717	$14,833	$383	30.9%
Michigan	873,241	$11,732	$224	22.9%	995,495	$15,252	$375	29.5%
Minnesota	404,484	$10,992	$236	25.8%	466,812	$14,290	$354	29.7%
Mississippi	239,457	$8,187	$195	28.6%	272,981	$10,643	$270	30.4%
Missouri	544,598	$10,397	$215	24.8%	620,842	$13,516	$317	28.1%
Montana	89,162	$10,199	$246	28.9%	101,645	$13,259	$300	27.2%
Nebraska	180,476	$11,133	$206	22.2%	205,743	$14,473	$320	26.5%
Nevada	123,072	$12,868	$188	17.5%	140,302	$16,728	$465	33.4%
New Hampshire	104,653	$11,552	$226	23.5%	119,304	$15,018	$377	30.1%
New Jersey	968,474	$12,674	$264	25.0%	1,104,060	$16,476	$405	29.5%
New Mexico	140,898	$10,003	$249	29.9%	160,624	$13,004	$323	29.8%
New York	3,257,259	$11,576	$252	26.1%	3,713,275	$15,049	$374	29.8%
North Carolina	645,865	$9,987	$225	27.0%	736,286	$12,983	$308	28.4%
North Dakota	71,149	$10,483	$203	23.2%	81,110	$13,628	$309	27.2%
Ohio	1,210,806	$11,078	$211	22.9%	1,380,319	$14,401	$338	28.1%
Oklahoma	327,955	$10,183	$205	24.2%	373,869	$13,238	$323	29.2%
Oregon	345,641	$11,311	$185	19.6%	394,031	$14,704	$386	31.5%
Pennsylvania	1,266,944	$10,840	$213	23.6%	1,446,596	$14,092	$336	28.6%
Rhode Island	139,515	$10,028	$250	29.9%	159,047	$13,036	$333	30.7%
South Carolina	307,422	$9,912	$254	30.8%	350,461	$12,886	$309	28.8%
South Dakota	74,521	$9,067	$234	31.0%	84,954	$11,787	$282	28.7%
Tennessee	508,422	$9,494	$188	23.8%	579,601	$12,342	$305	29.6%
Texas	1,759,679	$11,727	$310	31.7%	2,006,034	$15,245	$369	29.0%
Utah	131,396	$11,390	$311	32.8%	149,791	$14,807	$353	28.6%
Vermont	55,765	$9,768	$247	30.3%	63,572	$12,696	$336	31.8%
Virginia	641,483	$12,103	$216	21.4%	731,291	$15,734	$389	29.6%
Washington	529,188	$11,647	$218	22.5%	603,274	$15,141	$381	30.2%
West Virginia	181,390	$9,670	$252	31.3%	206,785	$12,571	$293	27.9%
Wisconsin	524,894	$11,705	$198	20.3%	598,379	$15,217	$351	27.7%
Wyoming	50,972	$13,875	$243	21.0%	58,108	$18,039	$378	25.1%
TOTAL	28,592,838	$11,331	$255	27.0%	32,595,835	$14,730	$365	29.7%

Source: Low Income Housing Information Service. Estimated by Cushing Dolbeare from 1980 Census data.

COMMENTS ON SPECIFIC PROVISIONS OF H.R. 3838

(Addendum to testimony of Barry Zigas, 2/6/86)

Depreciation Provisions

Section 168 of the bill creates a new Incentive Depreciation System. Under this system, real estate in general receives 30-year, straight line treatment. So-called "Low Income Housing", where either 25 percent of the units are rented to tenants at 80 percent of median, or 20 percent at 70 percent, receive 30-year, 200 percent treatment. "Very Low Income Housing", with 40 percent of the tenants at 60 percent of median, receives 20-year, 200 percent treatment.

Compared with current law, these provisions have the following impact on investors:

Very Low Income properties:	depreciation over pay-in period is 22 percent less than current.
Low Income Properties:	depreciation over pay-in period is approximately 45 percent less than current.

The effect of these reductions is to make the development of these properties much less attractive to investors. Moreover, the very low income tier does not provide enough subsidy through the tax provisions to make an economically viable project. Other, additional subsidies would be necessary in all areas to make this tier work, making it highly unlikely that very many such projects will be undertaken. H.R. 3838 creates the illusion of greater targetting for projects serving an increased number of low income renters without the substance necessary in a post-Section 8 environment.

Recapture Provisions

Section 202 of the bill provides that the full amount of additional depreciation in excess of straight line is taxed at ordinary income rates upon sale, without an exception for low income properties. Current law provides for a 200-month phase out of recapture provisions, an incentive for investors at the front end, and a deterrent to early disposition of the properties.

The current law provision should be retained.

Historic Tax Credit

Section 232 changes the historic tax credit to 10 percent for 30-year property, 20 percent for certified historic properties. Housing is eligible if certified historic property, regardless of occupants' income levels.

The Historic Tax Credit should include low income housing in both categories.

Section 167(k)

Section 223 eliminates the sunset provision of Sec. 167(k), which provides for 5-year depreciation of eligible rehab expenses for units occupied by qualified low income tenants. The section also increases the maximum amount of rehab expense which qualifies from $20,000 to $30,000, but eliminates a provision in current law providing a higher exception of $40,000 under special circumstances.

The $30,000 cap may create problems for projects in high cost areas needing extensive repairs. The cap is unnecessary in a post-Section 8 environment, since in order to qualify for the write off, qualified tenants must be able to afford the after rehab rents regardless of how large or small a write off is taken. The cap is merely an artificial constraint and is unnecessary.

The Committee's report on H.R. 3838 indicates that qualifying income for 167(k) tenants should be 50 percent or less of median income. This is a major change from current practice, set at 80 percent of median. In the absence of additional subsidies, it is highly likely that many potential 167(k) deals will not proceed because tenant income at the lower limit will not be sufficient to carry the economic costs of the project.

At-Risk Rules

Section 401 of H.R. 3838 extends the at-risk provisions of the Code to real estate transactions, except for those involving "qualified non-recourse financing." This excludes take-back or owner financing. **This will be a major and potentially crippling obstacle for the preservation of existing low income properties in which current investors have exhausted their tax advantages and are interested in selling to new owners. Without the availability of favorable seller financing, many of these deals cannot be done and still preserve rents at levels which present low income tenants can afford. The exception in H.R. 3838 works fine to protect the for-profit or nonprofit developer of new or substantially rehabilitated housing. It cripples the critical area of resyndication of existing low income housing.**

This section should be amended at least to provide for exclusion of at-risk provisions where financing is used to restrict use to low income housing, regardless of its source.

Limitations on Reduction in Business Interest

Section 163(d)(1) is amended to limit the amount of nonbusiness interest allowable as a deduction to $10,000 ($20,000 on joint returns) plus net investment income.

Business interest from projects qualifying as very low income (but not low income) regardless of their financing source, Section 167(k) projects, and low income projects using tax-exempt financing are eligible, but not low income projects using taxable financing. The most immediate consequence of this provision is to jeopardize the eligibility of projects financed through the Farmers Home Administration but otherwise meeting the requirements of the low income tier from taking advantage of the favorable treatment of business interest afforded other, tax-exempt projects with like tenancies.

This inconsistency has no firm basis and should be eliminated.

Alternative Minimum Tax

Title V of H.R. 3838 establishes a new minimum tax system which has potentially disastrous consequences for investment in low income rental housing. In fact, the effects may be so severe that all of the other preferences placed in the bill to facilitate such investment may be rendered useless as a result.

The major problems with this section include the apparent re-introduction of at-risk treatment of excess passive investment and the restriction on depreciation losses by requiring a nonincentive depreciation determination. By limiting total business losses which are exludable under the AMT to only $50,000, H.R. 3838 provides a severe disincentive for very high income taxpayers to invest in low income housing partnerships. The impact of these changes will be most severe on highly leveraged, very deep shelters, as well as those financed by very high income taxpayers.

At a minimum, investment in low income housing should be excluded from these considerations. **However, the National Low Income Housing Coalition believes that such an exception should be provided only if the recommendations for further changes to the bill are adopted to increase the actual degree of targetting and protection for low income tenants are adopted.**

National
Low Income Housing Coalition
1012 Fourteenth Street, N.W., Suite 1006, Washington, D.C. 20005 • (202) 662-1530

Hon Edward W Brooke, *Honorary Chairperson*
Barry Zigas, *President*

SUMMARY OF RECOMMENDATIONS FOR NEW PROVISIONS FOR LOW INCOME HOUSING IN H.R. 3838

1. Predominantly Low Income Housing (PLIH)

H.R. 3838 is extremely prejudicial to the 600,000 units of existing, already subsidized HUD-FHA-insured multifamily rental housing. This housing is reaching the end of the tax recapture period from its initial construction, and owners are seeking to recover their equity after nearly 20 years. Favorable tax treatment is essential to help structure transfers of these properties which assure the continued availability of the units to the low income tenants now being served.

H.R. 3838 also provides no incentives to develop property for predominantly low income use. This is a major retreat from current law, which provides the most generous depreciation treatment for properties which do serve a predominantly low income tenancy.

The Senate Finance Committee should adopt a new class of rental property: Predominantly Low Income Housing (PLIH). Qualifying projects would include:

- Any project--existing, newly constructed, or rehabilitated--in which 80 percent or more of the units are occupied by households with incomes below 80 percent of area median, adjusted for family size.
- Any project insured under Section 236 or Section 221(d)(3)(BMIR) of the National Housing Act, as amended, or the direct loan programs of the Farmers Home Administration under Title V of the National Housing Act, as amended.

Such properties would qualify for the following special consideration:

- Depreciation of investment on a 10-year, 200 percent schedule. Recapture of all depreciation benefits would occur if transfer occurred within the first 10 years, with the penalty declining over the second 10 years to zero. Transfer to any purchaser which agrees to maintain low income occupancy, or to a qualified limited equity low income cooperative during the first 20 years would exempt the seller from recapture.

- This depreciation treatment would apply to acquisition as well as development, construction, or rehabilitation expenses.

- PLIH acquisition could be financed through the issuance of tax-exempt housing bonds. Bonds issued for this purpose would be classified as serving an "essential governmental purpose" and be exempt from any other volume or issuance caps enacted.

- PLIH properties would be excluded from at-risk treatment, as outlined below, and from limitations on business interest. Income and losses from PLIH investments would not be treated as preference items for purposes of the alternative minimum tax.

2. Qualifying as "Mixed Income Housing"

H.R. 3838 adopts two specific means by which to qualify for special tax treatment in rental housing. It calls these "low income housing" and "very low income housing". Both descriptions are inaccurate--the targeting thresholds provided for (at least 25 percent low income occupancy in the one case, and at least 40 percent occupancy in the other) only provide for "Mixed Income Housing." The separate classes established by H.R. 3838 should be replaced by a single definition of **"Mixed Income Housing"** requiring that:

- At least 20 percent of the units occupied by households with incomes below 80 percent of median.

- At least 10 percent of the units occupied by persons below 50 percent of median.

The remaining 70 percent of the units may be occupied by any household, and may be rented at whatever the market will bear. All targeted units, however, must rent at not more than 30 percent of 80 percent (or 50 percent for the 10 percent set-aside) of the area median.

Projects which meet the minimum targeting requirements of the **Mixed Income Housing** definition would qualify for a 20 year, 200 percent depreciation schedule. This still represents a 39 percent reduction from the benefits now available under the 15 year, 200 percent depreciation available to low income housing. This schedule should permit the widespread use of this targeted program, however.

3. Projects exceeding the minimum targeting requirements

Particularly in the nonprofit sector, sponsors may want to exceed the minimum targeting requirements of the Mixed Income Housing definition, but not reach those of the Predominantly Low Income Housing definition. In instances where the owners provide more than the minimum number of units to either those below 80 percent or 50 percent, each additional unit over the threshold shall receive 5-year, 100 percent depreciation through the provisions of Section 167(k), on a unit-by-unit basis as long as the unit is occupied by a qualified tenant. This provides a substantial incentive for attracting investment capital to projects exceeding the minimums.

4. Tax exempt bond authority

Projects meeting the minimum threshold for Mixed Income Housing or Predominantly Low Income Housing would qualify for IDB financing. The present cap on IDB issuances should be abandoned, or housing should at the very least be provided a cap outside the other bond limits imposed. In any case, PLIH issuances should be qualified as an "essential governmental purpose" and remain outside any caps imposed.

5. Other real estate provisions--At Risk and Interest Limitations

All projects qualifying as either Predominantly Low Income Housing, Mixed Income Housing, or units developed through Section 167(k) would be exempt from the **at-risk** limitations and the **interest limitations.** The **at-risk** exemption must be amended in Section 401 of H.R. 3838 so that qualified nonrecourse financing includes a new paragraph: "(e) which is used to acquire interests in property which is used and will be maintained as PLIH." Seller financing plays a major role in the transfer of existing PLIH property. Many such transfers would not be possible without such financing. Already adopted legislation concerning the Original Issuer Discount (OID) rules have curbed the abuses which concerned Congress in this area. The limitation included in H.R. 3838 is very favorable to highly leveraged, profit motivated new production deals most likely to be carried out through the Mixed Income

Housing provisions outlined above. But the limitation is extremely prejudicial to the continued viability and maintenance of existing Predominantly Low Income Housing.

6. Alternative minimum tax

The Alternative Minimum Tax as presently structured in H.R. 3838 eliminates any incentive to participate in low income rental housing syndications, regardless of the targeting or depreciation schedules used. It even makes use of the 167(k) option very marginal.

The Senate Finance Committee should exempt investments in qualified Predominantly Low Income Housing Projects, in qualified Mixed Income Housing projects, or in projects qualifying under Section 167(k) from inclusion as a preference item in the alternative minimum tax. **However, exemption should be premised on the adoption of the more stringent targeting requirements outlined above.**

7. Use restrictions on qualified properties

H.R. 3838 should be amended to require a use restriction on any bond-financed property or any property qualifying for treatment as Predominantly Low Income Housing or Mixed Income Housing of no less than 15 years from the start of full occupancy. The current use restriction of the greater of 15 years or the maturity of the bonds financing the project is impractical. It will discourage the use of longer term financing to carry out projects without providing any substantial increase in term of use for the affected tenants.

8. Anti-displacement provisions

H.R. 3838 should be amended to include stiff prohibitions against the use of tax-exempt financing in instances where low or very low income households will be displaced by those of higher income.

9. Qualifying low income, limited equity coops for IDB financing.

Under current law, cooperative multifamily housing projects do not qualify under the multifamily IDB provisions because of their unique characteristics. It is impractical to finance such developments using the single family bond program. Meanwhile, nonprofit sponsors throughout the country are gaining experience with the use of limited equity, low income cooperatives as an effective way to provide low cost housing over a long period of time to low income households. A strictly limited qualification should be enacted to facilitate the use of this model through IDB financing. Coops should be required to meet the PLIH standards to qualify for IDB financing, and should be required to meet certain additional standards concerning equity appreciation and long term use of the property as Predominantly Low Income Housing.

The **Chairman**. Mr. Maffin.

STATEMENT OF ROBERT W. MAFFIN, EXECUTIVE DIRECTOR, NATIONAL ASSOCIATION OF HOUSING AND REDEVELOPMENT OFFICIALS

Mr. **Maffin**. Thank you, Senator Garn.

My name is Robert Maffin. I am the executive director of NAHRO, the National Association of Housing and Redevelopment Officials that represents several thousand individuals and about 2,000 local agencies around the country, administering housing and community development and redevelopment programs.

Normally, we come before this committee to talk about authorizations and appropriations for these programs. Today we're here to talk about the impact of H.R. 3838 on these programs vis-a-vis tax reform.

One of the things that occurs to us is that in this tax reform discussion, too little attention has been paid to the broad public purposes and the positive economic impact of tax expenditures. They have, indeed, been smothered by and large in the discussion. Like budget expenditures, tax expenditures play a vital role in meeting national goals. Particularly, is this very crucial in these times when direct Federal expenditures in these areas have been severely eroded.

NAHRO believes that the tax incentives should be targeted to meet the national goal of providing a decent home and a suitable living environment for every American family and to revitalize physically and economically distressed areas of our country.

In 1974, this Congress—this committee, as a matter of fact—in the Housing and Urban Development Act of that year, declared that the health and vitality of our cities, as well as the neighborhoods and the housing that people live in are essential to the general welfare and the security of the Nation.

We believe that tax incentives, tax expenditures, should be viewed against those kinds of public goals or objectives that this Congress on similar occasions has established and repeated.

Let me turn now to just two or three areas of coverage that relate directly to the interests of this committee and to my association.

MULTIFAMILY HOUSING BONDS

Let me deal with multifamily housing bonds. We believe that these bonds should be continued and not subjected to the volume cap. Moreover, in another effort to more tightly target some of these efforts, for those units that are set aside for low income, one low-income family should have a rent to income ratio not exceeding 30 percent of the tenant's income.

We believe—and our testimony spells this out—that like others, the mortgage subsidy or the single-family bond should be more tightly targeted, in terms of income and purchase price.

With respect to a very special kind of development financing that has emerged over the last 40 years, the so-called tax increment financing, some 36 States have enabled their local governments to utilize this tool to help them eliminate areas of blight and deterioration. This public purpose tool, we think should be recognized as such, therefore, not under the volume cap. We think that this is a very, very important tool. It has been demonstrated in terms of its utility, as I said, in some 36 States.

Finally, there are a host of tax incentives relating to investment tax credits, historic buildings, older properties, tax credits, accelerated depreciation, all of which have value, if they are targeted in the two directions that we have suggested. Targeted first to meeting the needs of low- and moderate-income persons, and second, to meeting needs of areas of fiscal and economic distress. These incentives account for some 3 percent of all tax expenditures, and in our judgment, should not be reduced in order to achieve a revenue neutral bill.

Let me conclude, Senator, by simply saying that much of the incentive for this whole discussion on tax reform goes to the overriding perceived and real damage that our national deficit poses for our country and our economy. That being the case, we believe that a very prudent course of action, quite aside from tax reform, would be to have this Congress and this country initiate a tax increase dedicated solely to the reduction of the deficit, which is really damaging our country.

Thank you.

[The complete prepared statement follows:]

NAHRO National Association of Housing and Redevelopment Officials
2600 Virginia Avenue, Northwest, Suite 404, Washington, D.C. 20037 (202) 333-2020

Statement of
ROBERT W. MAFFIN
EXECUTIVE DIRECTOR
of the
NATIONAL ASSOCIATION OF HOUSING
AND REDEVELOPMENT OFFICIALS

on

TAX REFORM AND ITS IMPACT ON
HOUSING AND COMMUNITY DEVELOPMENT

Submitted to the
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES SENATE

February 6, 1986

Mr. Chairman, my name is Robert Maffin. I am the Executive Director of NAHRO. Mr. Joe Gray, our Vice President for Community Revitalization and Development, who was supposed to testify, was unable to be here this morning. Consequently, I will present NAHRO's views.

As you know, NAHRO is a 51-year-old association of professionals who administer low-income housing, rehabilitation, and community development programs in localities across the country. We represent over 5,000 individuals and 2,000 local agencies involved in carrying out these programs. We appreciate this opportunity to comment on the impact of tax reform on housing and community development efforts.

NAHRO is supportive of the basic goals of tax reform in terms of making the code more equitable and redistributing the burden of taxation. However, these reforms should not be at the expense of efforts to more directly involve the private sector, through tax incentives, in providing housing for low-income persons and improving our neighborhoods.

A major problem with the current debate on federal tax reform is that the broad public purpose and positive economic impact of tax expenditures has not been rasied as an issue for consideration. Like budget expenditures, tax expenditures play a vital role in meeting the national goal of providing a decent home and a suitable living environment for every American family. Over the past few years, direct federal funding of housing and community development programs has been severely eroded. Current tax reform proposals similarly threaten the ability of state government, local government, and nonprofit organizations to generate investment in low- and moderate-income housing and areas of physical and economic distress.

Tax incentives, by stimulating investment that would not otherwise occur, provide critical funds to house the poor and revitalize distressed areas. Tax-exempt multifamily housing bonds, when combined with incentives such as favorable depreciation rates, enable local agencies to construct housing within the reach of lower income citizens. Single family mortgage subsidy bonds make homeownership affordable to first time home buyers whose incomes would not otherwise allow them to purchase their own home. Tax credits for rehabilitation, by lowering the cost and risk to the investor, make the rehabilitation of substandard units economically feasible at lower rental rates and thus make housing more affordable to lower income tenants.

Tax incentives play a similar role in the revitalization of blighted areas in our cities and towns. Tax-exempt bond financing, such as tax increment bonds, allows local governments to conduct the necessary land assembly and public improvements to attract private investment. Investment tax credits, rapid depreciation, and other inventives attract private investment that would otherwise locate in less risky areas. Industrial development bonds allow government to play a more direct role when needed to steer resources to distressed areas and to make an investment economically viable.

NAHRO believes tax incentives should be targeted to meet the national goal of providing a decent home for every American family and revitalizing the physically and economically distressed areas of our country. Rather than eliminating or restricting incentives across-the-board, tax policy should explicitly direct tax expenditures to meet public goals. These incentives I am addressing today should be judged in terms of the benefits they achieve in improving housing opportunities and redeveloping distressed areas of our cities.

I would now like to address some of the tax incentives relating to activities under your Committee's jurisdiction which we feel are important and should be retained, with some modification in a few cases. These modifications are suggested to more directly target these incentives and tax expenditures to benefit low- and moderate-income persons and distressed areas.

MULTI-FAMILY HOUSING DEVELOPMENT BONDS

NAHRO strongly urges continuation of the ability to issue these bonds and that they not be subject to a state volume cap. Establishing such a cap would significantly and adversely affect a number of communities currently utilizing these bonds to produce housing with a set aside for low-income persons. For example, the cap currently included in the House bill would permit Sacramento, California, to produce only eleven percent of the units they did in 1985. Denver would be reduced to nineteen percent of their 1984 activity, and Montgomery County, Maryland, would be able to produce only eight percent of their 1985 activity. This reduction occurs when demand is increasing. Further, NAHRO also supports a provision insuring that rents for low-income set-aside units don't exceed thirty percent of the low-income tenant's income.

MORTGAGE SUBSIDY BONDS

The success of MRBs in providing single family housing is unquestioned. NAHRO urges continuation of this vehicle though we support more limited income and purchase price limitations. Bond proceeds should be required to be used to serve lower income households. Eligible users should also include persons in substandard housing and persons displaced by governmental action or disasters. A separate volume cap should be maintained for these bonds.

TAX INCREMENT FINANCING (TIF)

This financing tool, which allows local government to facilitate development, is authorized by state law in thirty-six states. TIF is used in conjunction with plans for residential, commercial, industrial, and public improvements within areas designated by states as redevelopment or blighted areas. Tax exempt bonds are issued by local public authorities for public improvements and to acquire and develop sites to encourage private investment in these areas. It is for these reasons that TIF and tax allocation bonds are public purpose governmental bonds which are essential functions and such classification should be affirmed in the tax code. This very important and critical tool should continue to be authorized and because of its governmental function should not be included under a volume cap.

INVESTMENT INCENTIVES

There are a series of other investment incentives which have a direct and positive impact on our local efforts to provide housing and improve distressed areas. These incentives, included in the current law, should be retained. These include the investment tax credit, historic buildings and older properties tax credit, and accelerated depreciation. These tools, with some more specific targeting to low- and moderate-income housing or physically or economically distressed areas, have been valuable tools in accomplishing public purposes as they pertain to housing and community development and for that reason should be continued.

For your use and information, I am submitting along with this testimony, and request that it be entered into the record, a more detailed statement of NAHRO's position on tax reform and a section-by-section commentary on H.R. 3838 as passed by the House.

In concluding, let me address one other major issue; that is the effect of tax reform on the budget and the budget deficit. As I have testified, NAHRO feels that the incentives and expenditures cited are critical to help us further our national goals and serve the needs of this country as they relate to housing and improving our neighborhoods. These incentives, which are less than three percent of all tax expenditures, should not be reduced in an effort to achieve a revenue-neutral bill. Further, NAHRO strongly supports efforts to reduce the budget deficit; however, we believe and strongly urge the President and the Congress to enact an increase in federal taxes specifically dedicated to deficit reduction. Such action will also permit tax reform to be accomplished on the merits of the specific tax incentives and tax expenditures rather than basing a decision on the impact of the deficit.

I thank you for this opportunity to express NAHRO's views on this most important subject and will be happy to answer any questions.

NAHRO

A NAHRO POSITION

Tax Reform Act Of 1985

Statement of the Issue

The Tax Reform Act of 1985 (H.R. 3838) proposes sweeping changes in the current federal tax structure. Among the many proposals in the bill are several that will severely restrict or eliminate tools to stimulate investment in housing and community development projects. Coupled with past and proposed reductions in direct expenditures for housing and community development programs, the curtailment of tax incentives will present local governments with a dramatic loss in their capability to revitalize distressed areas and provide adequate housing for low-and moderate-income persons.

NAHRO Position

NAHRO supports the following modifications in the Tax Reform Act of 1985 to retain the use of federal tax incentives to stimulate investment in low and moderate income housing, neighborhood revitalization, and redevelopment of physically and economically distressed areas:

- EFFECTIVE DATES. NAHRO supports an effective date of January 1, 1987, for changes in tax law. Otherwise the ability to issue bonds for housing and community development projects will be severely curtailed because of uncertainty as the tax reform bill is considered;
- MULTI-FAMILY HOUSING DEVELOPMENT BONDS. NAHRO urges that depreciation schedules, at least as favorable as in current law, be adopted. NAHRO also supports establishing ceiling rents at thirty percent of income for low-income set-aside units, and exempting multi-family housing bond issues from the state volume cap;
- MORTGAGE SUBSIDY BONDS. NAHRO supports excluding these bonds from a general state volume cap. A separate cap should be maintained as in current law. NAHRO also supports extension of eligible users to include persons in substandard housing and persons displaced by a disaster or government action. Use of bond proceeds should be restricted to households at or below 120% of median income;
- GOVERNMENTAL BONDS. NAHRO supports defining governmental bonds and non-governmental bonds as in current law, rather than the H.R. 3838 five percent/ten percent test for "non-essential function" bonds. NAHRO opposes further restriction of eligible activities;
- TAX INCREMENT FINANCING. NAHRO supports defining tax increment financing issues as governmental bonds (or "essential function bonds") subject to certain targeting requirements being met. NAHRO opposes the classification of tax increment financing bonds as "non-essential function bonds" and the placement of these bonds under a general volume cap; and
- INVESTMENT INCENTIVES. NAHRO supports the retention of general tax

credits and investment incentives at current levels, subject to these incentives being targeted to low-and moderate-income housing, or physically or economically distressed areas. These include the investment tax credit, historic buildings and older properties tax credit, and accelerated depreciation.

Current Program Status

The federal tax code is not only a mechanism for raising revenue. As direct federal financing has declined, tax incentives linked to housing and community development programs have become important financing tools for state and local governments. Tax incentives, by stimulating investment that would not otherwise occur, provide funds to house the poor and revitalize distressed areas. Tax-exempt multifamily housing bonds, when combined with incentives such as favorable depreciation rates, enable local agencies to construct housing within the reach of lower income citizens. Single family mortgage subsidy bonds make homeownership affordable to first- time home buyers whose incomes would not otherwise allow them to purchase their own homes. Tax increment bonds allow local governments to conduct the necessary land assembly and public improvements to attract private investment. Investment tax credits, rapid depreciation, and other incentives attract private investment that would otherwise be made in less risky areas. Industrial development bonds allow government to play a more direct role when needed to steer resources to distressed areas and to make an investment economically viable.

In calendar year 1984, state and local governments issued $55.6 billion in non-governmental bonds. These included $20.4 billion in housing bond issues, $17 billion in industrial expansion bond issues, and $7 billion in sewage and waste disposal issues. Total activity in non-governmental bonds exceeded the proposed single volume cap by 32%; because of changes in what is counted under the cap, the actual impact of the volume cap would be greater.

Background

As the system of exemptions, credits, and deductions has expanded in number and complexity in the tax code, there has been growing concern that the tax system must be simplified and be made more equitable. In a time of growing deficits, the cost of these "tax expenditures" has been a related concern. In early 1985, the Reagan Administration presented proposals to simplify the tax system, reduce the number of brackets, eliminate a number of tax preferences, and reduce maximum rates. The impact on housing and community development, and local government in general, was dramatic. The plan proposed elimination of deductability of state and local taxes, elimination of tax exemption for housing bond issues, elimination of tax exemption for other industrial development bonds, and termination of most incentives for investment in real estate.

The House Ways and Means Committee began consideration of tax reform using the basic principles of the Reagan plan. The Ways and Means proposal was passed as H.R. 3838 in December 1985. The bill is generally more favorable to housing and community development than the original proposals. The result, however, is still a loss in the financing tools available to state and local governments to finance housing and community development programs.

January 1986

TARGETING TAX INCENTIVES TO LOW AND MODERATE INCOME HOUSING AND AREAS OF PHYSICAL AND ECONOMIC DISTRESS

Current debate on federal tax reform has considered various tax incentives in isolation. There has been little discussion of the appropriateness of the use of specific incentives. Rather, the fate of each item rests on the degree of pressure brought by various interests. The broad public purpose of tax expenditures as well as tax collection mechanisms has not been raised as an issue for consideration.

Like budget expenditures, tax expenditures play a vital role in meeting the national goal of providing a decent home and a suitable living environment for every American family. Over the past few years direct federal funding of housing and community development programs has been severely eroded. Current tax reform proposals similarly threaten the ability of state government, local government, and nonprofit organizations to generate investment in low- and moderate-income housing and areas of physical and economic distress.

Tax incentives, by stimulating investment that would not otherwise occur, provide critical funds to house the poor and revitalize distressed areas. Tax-exempt multifamily housing bonds, when combined with incentives such as favorable depreciation rates, enable local agencies to construct housing within the reach of lower income citizens. Single family mortgage subsidy bonds make homeownership affordable to first time home buyers whose incomes would not otherwise allow them to purchase their own home. Tax credits for rehabilitation, by lowering the cost and risk to the investor, make the rehabilitation of substandard units economically feasible at lower rental rates and thus make housing more affordable to lower income tenants.

Tax incentives play a similar role in the revitalization of blighted areas in our cities and towns. Tax-exempt bond financing, such as tax increment bonds, allows local governments to conduct the necessary land assembly and public improvements to attract private investment. Investment tax credits, rapid depreciation, and other incentives attract private investment that would otherwise locate in less risky areas. Industrial development bonds allow government to play a more direct role when needed to steer resources to distressed areas and to make an investment economically viable.

Tax reform advocates have raised the concern of greater simplicity and fairness in the collection of tax revenues, a concern that is widely shared. A complicated combination of preferences that have arisen under the tax code seems in many instances to violate these principles. One sector of the economy is favored over another; one business receives breaks where another does not. The public purpose for these preferences is not clearly defined, yet other sectors or persons must pay the costs of these expenditures through higher taxes.

The result of tax reform thus far has been the proposal to discard certain tax credits and exemptions without regard to how the preferences are used. The issue is not whether a particular tax preference itself is good or bad; the issue is not solely whether a particular group is better or worse off with a change in the tax code; the issue is whether the tax expenditure does or does not address a clearly defined public goal.

Targeting tax incentives to meet the national goal of housing the poor and revitalizing the physically and economically distressed areas of our country has been absent from the debate. Targeting, however, can change a high cost tax preference to a low cost one that provides public agencies needed funds to meet their publicly mandated responsibilities. Targeting can change a vague tax incentive with no clearly defined public purpose to a controlled expenditure directed to a public goal. To date, however, the issue of targeting has not figured largely in the debate over tax reform.

Million of Americans remain ill-housed. Unemployment and underemployment continue at high levels in many cities, particularly for the poor and minorities. Blighted conditions undermine the social and economic structure in too many neighborhoods, and too many have already been destroyed.

The consequences of any action that affects our ability to solve these problems should be a matter of debate. NAHRO believes that the general targeting of tax incentives for investment to benefit low- and moderate-income persons or areas of physical and economic distress should be seriously discussed as part of the debate on tax reform. Rather than restricting or eliminating incentives across the board, they can be limited to areas of public concern. Tax policy should explicitly direct tax expenditures to meet public goals, just as the method for generating tax revenues attempts to take into account social goals. These expenditures should be judged in terms of the benefits they achieve in improving housing opportunities and redeveloping distressed areas of our cities.

NAHRO supports the use of federal tax incentives to encourage private investment in low- and moderate-income housing, neighborhood revitalization, and redevelopment of physically and economically distressed communities. NAHRO urges that this position be incorporated in any discussions of tax policy or proposals for tax reform.

FEDERAL TAX POLICY FOR HOUSING AND COMMUNITY REVITALIZATION

Comparison of the House Ways and Means Committee Bill (Tax Reform Act of 1985)
and NAHRO's Tax Policy Position

Current Law	H.R. 3838	NAHRO Position
I. LOW-INCOME MULTIFAMILY HOUSING		
A. Tax-exempt IDBs	Title VII, Section 701. "Section 141(b)" p.513, and "Section 142(c)" p.516.	
Tax-exempt IDBs can be used for multifamily housing under the following condition: 20% (15% in targeted areas) or more units are set aside for households at or below 80% of median income when the unit is first rented.	Tax-exempt bonds could be used for multifamily housing under the following three circumstances: a. 25% or more units are set aside for households at or below 80% of median income (adjusted for household size). b. 20% or more units are set aside for households at or below 70% of median income (adjusted for household size). c. 40% or more units are set aside for households at or below 60% or median income (adjusted for household size).	NAHRO supports the retention of tax-exempt bonds for low-income multifamily housing. NAHRO supports the Committee's decision to retain tax-exempt bonds for multifamily housing. NAHRO is concerned, however, that less low-income housing may be built under the stricter low-income-unit set-asides when coupled with the Committee's decision to lengthen the depreciation period and impose a 25% minimum tax. NAHRO believes more evidence is needed to show that low-income housing would be financially feasible under the Committee's configuration of tax incentives.
The building must be used as rental housing for 10 years or 50% of the term of the bonds with longest maturity.	Set-aside units must remain for low-income use for 15 years or until maturity of financing.	NAHRO supports the Committee's decisions on minimum term of use by low-income households.

FEDERAL TAX POLICY FOR HOUSING AND COMMUNITY REVITALIZATION
Page Two

Current Law	H.R. 3838	NAHRO Position
I. LOW-INCOME MULTIFAMILY HOUSING		
A. Tax-exempt IDBs (cont'd)	Title VII, Section 701. "Section 143(c)(2)(b)," p.517.	
Treasury will require family-size adjustments after December 31, 1985.	The Committee accepted the Treasury's new definitions for household size adjustments. Low-income for a family of four is defined as 80% of areawide median income (for smaller households, low-income is adjusted below 80%, and for larger households low-income is adjusted above 80%).	NAHRO supports the Committee's decision on household income adjustments. NAHRO also supports limitations on the amount of rent required from households in set-aside units. NAHRO's position is that households in such units pay no more than 30% of monthly income for rent.
B. Depreciation	Title II, Section 201. "Section 168(e)(2)."	
Low-income housing is depreciated over 15 years at 200% declining balance, switching to straight line.	75/25 and 80/20 housing (see above) would be depreciated over 30 years at 200% declining balance. 60/40 housing (see above) would be depreciated over 20 years at 200% declining balance.	NAHRO supports retention of accelerated depreciation for low-income housing. NAHRO favors current law over the Committee's decision unless evidence can be provided that the lengthened depreciation periods will not adversely affect investment in low-income housing.
C. Exemption from "At-Risk" and Interest Deduction Cap	Title IV, Section 401, p.325 and Section 402(a). "Section 163(d)(6)(B)" p.335.	
Low-income and other residential property are exempt from "at-risk" rules.	The exemptions are preserved for low-income housing as defined above.	NAHRO supports the Committee's decisions to retain the "at-risk" and interest deduction cap exemptions.

FEDERAL TAX POLICY FOR HOUSING AND COMMUNITY REVITALIZATION
Page Three

Current Law	H.R. 3838	NAHRO Position
I. LOW-INCOME MULTIFAMILY HOUSING (cont'd)		
D. Construction Period Interest		
Low-income housing can deduct construction period interest in the first year. Other residential property can amortize construction period interest over 10 years.	The Committee decision requires capitalization of interest on debt incurred in building all property over the property's tax life.	NAHRO favors retention of current provisions for low-income housing but to extend the provisions also to investment in physically and economically distressed areas. NAHRO is concerned that the Committee's decision will make such investments riskier relative to other investments.
E. Accelerated Depreciation Recapture	Title II, Section 201, p.126.	
Gain on residential property held over one year is recaptured only insofar as it exceeds straight-line depreciation. Low-income housing accelerated depreciation recapture is phased out at 1% per month after 100 months.	Present law is maintained (for low-income housing this means that after the first 100 months the recapture provision is phased out at 1% per month). The difference between accelerated and straight-line depreciation is recaptured as income.	NAHRO supports the Committee's action.
F. Section 167(k) Rehablitation Cost Expensing	Title II, Section 223, p.156.	
Allows five-year depreciation of rehab investment for low-income units. The provision would expire without reauthorization.	Five-year amortization of rehabilitation investments is maintained for bond-financed low-income housing and 60/40 housing (see above) with or without bond-finanging. The maximum per unit cost is set at $30,000. The provision is made a permanent piece of tax law.	NAHRO supports the Committee's decision.

FEDERAL TAX POLICY FOR HOUSING AND COMMUNITY REVITALIZATION
Page Four

Current Law	H.R. 3838	NAHRO Position
II. LOW- AND MODERATE-INCOME SINGLE-FAMILY HOUSING		
A. Tax-exempt Mortgage Subsidy Bonds (MSBs)	Title VII, Section 701. "Section 141(b)", p.513 and "Section 143 , p.519.	
At least 90% of lendable proceeds must go to finance mortgages on single-family, owner-occupied residences for first-time homebuyers.	All lendable proceeds are required to be used to finance residences for first-time homebuyers.	NAHRO supports the Committee's decision to retain tax-exempt bonds for low- and moderate-income single-family housing bonds. NAHRO favors, however, extending eligibility to persons living in substandard housing and persons displaced by disaster or governmental action.
Purchase prices are limited to 110% (120% in targeted areas) of average area purchase price.	Purchase price limits are reduced to 90% (110% in targeted areas) of area average purchase prices.	NAHRO supports the Committee's decision on purchase price limits.
	Income limits are imposed. a. 50% of loans made to borrowers at or below 90% of area median income. b. All loans made to borrowers at or below 115% of state or area median income. c. In targeted areas, one-third of loans made to the above income limits; two-thirds of loans made to borrowers with incomes not exceeding 140% of state or area median income.	NAHRO favors limiting bond-financed single-family housing programs to households with incomes at or below 120% of state or areawide median income.

FEDERAL TAX POLICY FOR HOUSING AND COMMUNITY REVITALIZATION
Page Five

Current Law	H.R. 3838	NAHRO Position
II. LOW- AND MODERATE-INCOME SINGLE-FAMILY HOUSING (cont'd)		
B. Mortgage Credit Certificates		
MCCs could be issued in lieu of bond authority.	MCCs could be issued in lieu of bond authority. Mortgage loans with MCCs would be subject to the above restrictions.	
C. The provision is scheduled for sunset on December 31, 1987.	The provision is scheduled for sunset on December 31, 1987.	NAHRO favors making this provision a permanent part of the law.
III. CAPITAL GAINS TREATMENT OF INCOME	Title II, Section 241, P.212.	
60% of an individual's net capital gains would be deductible.	40% of an individual's net capital gains would be deductible.	NAHRO supports retention of current (60%) capital gains treatment for investment in low- and moderate-income housing and in physically and economically distressed areas.
IV. TAX-EXEMPT BONDS	Title II, Section 701. "Section 141(a)," P.511.	
A. Definition of Non-essential Function Bonds*		
General: (Consumer Loan Bonds) Interest on state and local bonds are taxable if: a. The bonds are used as IDBs. b. More than 25% of proceeds are used in a trade or business.	General: A bond is non-essential if an amount in excess of the lesser of (a) 10% or $10 million were used in a trade or business other than a governmental unit, or (b) 5% or $5 million were used to make loans to a person or business other than a governmental unit.	NAHRO opposes the Committee's definition of essential and non-essential bonds and the elimination of certain activities from tax-exempt status. NAHRO favors definition of essential or "governmental" bonds based on the definition of public purpose in current law and retention of the current eligibility requirements for tax-exempt status.

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*"Non-essential function" is a new term coined for H.R. 3838. In previous draft, the Ways and Means Committee used the term "non-governmental."

FEDERAL TAX POLICY FOR HOUSING AND COMMUNITY REVITALIZATION
Page Six

Current Law	H.R. 3838	NAHRO Position
II. TAX-EXEMPT BONDS		
A. Definition of Non-essential Function Bonds (cont'd)	Title II, Section 701. "Section 141(a)," p.511.	
c. Repayment of bonds is secured by property to be used in such a trade or business. d. General obligation bonds, housing bonds, student loan bonds, and IDBs (see below) are exempt from this provision.		
	Specific: Certain uses (see below) are automatically considered non-essential bonds.	
		To strengthen the public purpose requirement, NAHRO recommends that tax-exempt non-governmental bonds, with the exception of those for low-income housing, be targeted to UDAG-eligible areas or qualified redevelopment areas as defined under state law.

FEDERAL TAX POLICY FOR HOUSING AND COMMUNITY REVITALIZATION
Page Seven

II. TAX-EXEMPT BONDS

Current Law	H.R. 3838	NAHRO Position
A. Definition of Non-essential Function Bonds (cont'd)	Title II, Section 701. "Section 145," p.562.	
B. Volume Cap		
There is no single volume cap for all non-governmental bonds.	The total of a state's non-essential bonds are subject to a single volume cap.	NAHRO opposes a single cap for all "non-governmental" bonds. NAHRO favors a separate cap for single-family bonds and exempting multi-family bonds from any cap. If this cannot be obtained, NAHRO favors a separate combined cap for single- and multi-family housing bonds.
a. No limitation on low-income multifamily housing IDBs.	a. In each state the annual limitation would be the greater of $200 million or $175 per capita (reduced to $125 per capita in 1988).	
b. Mortgage bonds are limited to the greater of: 9% of the average annual aggregate principal amount of mortgages executed during the three preceding years; or $200 million.	b. A portion of the volume limit equal to $25 per capita would be reserved for 501(c)(3) organizations.	
c. Other IDBs and Student Loan Bonds are limited to the greater of: $150 per state resident or $200 million.	c. Less the $25 per capita (see above), one-half would be set aside for housing bonds. Of the housing set-aside, one-third would be used for single-family, one third for multi-family, and one-third at the governor's discretion.	

FEDERAL TAX POLICY FOR HOUSING AND COMMUNITY REVITALIZATION
Page Eight

II. TAX-EXEMPT BONDS

Current Law	H.R. 3838	NAHRO Position
B. Volume Cap (cont'd)	Title II, Section 701. "Section 145," p.562.	
	d. With the exception of the $25 per capita allocation for 501(c)(3) organizations, state statute could modify the set-aside to housing. Gubernatorial action could alter the allocation of housing bonds to single- and multi-family housing.	
	e. With the exception of the $25 per capita allocation for 501(c)(3) organizations, 5% is set-aside for tax allocation (TIF) bonds. This allocation could be modified by state statute or gubernatorial action.	
C. Essential Function Bonds	Title VII, Section 701(a), p.509 and Section 701, "Section 141(a)5," p.513.	
Interest on bonds issued by or on behalf of state or local government is tax-exempt so long as proceeds are used to finance government operations (includes general revenue, general obligation, and tax assessment bonds).	General obligation, revenue, and tax assessment bonds would not be subject to the state bond volume cap.	NAHRO supports the Committee's decision. NAHRO favors adding tax allocation (TIF) bonds to the list of essential function bonds.

FEDERAL TAX POLICY FOR HOUSING AND COMMUNITY REVITALIZATION
Page Nine

II. TAX-EXEMPT BONDS (cont'd)

D. Eligible Tax-exempt Bond Uses — Title II, Section 701. "Section 142," p.515.

Current Law	H.R. 3838	NAHRO Position
The following are eligible users of tax-exempt bonds: 1. Multi-family rental housing (80/20 housing) 2. Sports facilities 3. Convention or trade facilities 4. Airports 5. Docks and wharves 6. Mass commuting facilities 7. Parking facilities 8. Sewage disposal facilities 9. Solid waste disposal facilities 10. Electric energy and gas furnishing facilities serving areas not exceeding two contiguous counties or a city and one contiguous county 11. Certain facilities furnishing water 12. Certain hydroelectric generating facilities	Unless otherwise indicated, facilities would have to be governmentally owned. 1. Multi-family rental housing (private housing) 2. Airports (not subject to the State volume cap) excluding hotels and restaurants in airports 3. Ports 4. Mass commuting facilities 5. Sewage and solid waste disposal facilities (including privately owned and operated facilities) 6. Facilities for furnishing water (governmentally owned or operated or for which rates are governmentally established) 7. Small issue IDB (under present law) 8. Qualified student loan bonds (under present law) 9. Qualified mortgage bonds (see above)	NAHRO favors tax-exempt bonds for all public facilities. NAHRO defines public facilities as those which are owned, managed, financed, or regulated by a governmental body.

FEDERAL TAX POLICY FOR HOUSING AND COMMUNITY REVITALIZATION
Page Ten

II. TAX-EXEMPT BONDS

D. Eligible Tax-exempt Bond Uses (cont'd) — Title II, Section 701. "Section 142," p.514.

Current Law	H.R. 3838	NAHRO Position
13. Local district heating and cooling facilities 14. Air or water pollution control facilities	10. Qualified veterans' mortgage bonds (private loans) 11. Uses by Section 501(c)(3) organizations 12. Qualified redevelopment (TIF) bonds.	
E. Ineligible Non-essential Bond Uses	1. Sports facilities 2. Convention or trade show facilities 3. Parking facilities (except airport parking) 4. Facilities for local furnishing of gas and electricity by investor-owned utilities 5. District heating or cooling facilities 6. Air or water pollution control facilities 7. Industrial parks	NAHRO supports tax-exempt bonds for these activities under its definition of public facility.
V. INVESTMENT TAX CREDIT	Title II, Section 211.	
10% tax credit for investment in real property capital improvements and expansion.	The regular ITC is repealed.	NAHRO supports retention of the ITC for low- and moderate-income housing and investments in physically and economically distressed areas

FEDERAL TAX POLICY FOR HOUSING AND COMMUNITY REVITALIZATION
Page Eleven

Current Law	H.R. 3838	NAHRO Policy
VI. REHABILITATON TAX CREDIT		
A. Older Buildings Act	Title II, Section 232, p.117.	
15% tax credit for rehab investment in buildings older than 30 years. 20% tax credit for rehab investment in buildings older than 40 years.	Buildings built before 1935 qualify for a 10% tax credit for rehabilitation investment.	NAHRO supports retention of current law for older and historic buildings used for low- and moderate-income housing and located in physically and economically distressed areas.
B. Historic Structures		
25% tax credit for rehab investment in registered historic buildings.	Qualified historic structures get a 20% tax credit for rehabilitation investment.	
VII. DEPRECIATION OF REAL PROPERTY	Title II, Section 201. "Section 168(c)," p.71 and Section 202, p.126.	
Real property low-income is depreciated over 18 years at 175% declining balance, switching to straight line.	A. With the exception of low-income multi-family housing (see above), residential property and other buildings would be depreciated over 30 years at 100% declining balance.	NAHRO supports retention of current accelerated depreciation for low-income housing and investments in physically and economically distressed areas.
Gain from accelerated depreciation on real property (non-low-income) is recaptured as income to the extent that it exceeds straight-ling depreciation.	B. Recapture: Because there is no accelerated depreciation, the recapture rules would not apply to non-low-income housing.	NAHRO is concerned that the Committee's proposals would decrease incentive for investment in low-income housing and in projects in physically or economically distressed areas relative to other investments.

FEDERAL TAX POLICY FOR HOUSING AND COMMUNITY REVITALIZATION
Page Twelve

Current Laws	H.R. 3838	NAHRO Position
VIII. RESIDENTIAL ENERGY TAX CREDIT	Title II, Section 271, p.247.	
40% tax credit for solar installations up to $10,000. 15% tax credit for investments in residential energy conservation up to $2,000.	A. Energy improvement tax credits are allowed to expire December 31, 1985. B. Solar Energy Investments: The tax credit is phased out over three years for businesses and individuals investing in solar energy devices. 1. The tax credit for individual investments is 30% in 1986, 20% in 1987, and 20% in 1988. 2. The tax credit for business investments is 15% in 1986, 12% in 1987, and 8% in 1988.	NAHRO supports retention of residential energy tax credits for low-income housing and investments in physically and economically distressed areas.

Current Law	H.R. 3838	NAHRO Policy
IX. TAX INCREMENT FINANCING BONDS		
	Title VII, Section 701 "Section 144(d)", p557	
Provisions of DEFRA of 1984 put TIF in jeopardy as a "consumer loan bond." Local governments are authorized by state law to issue TIF bonds for eligible, locally designated "blighted" or redevelopment areas. TIF bonds are tax-exempt, local government obligations.	A. General: Tax increment financing (TIF) or tax allocation bonds are covered under the section on Qualified Redevelomment Bonds (QRBs) if the lesser of 10% or $10 million of proceeds are used in a private trade or business, or the lesser of 5% or $5 million of proceeds is used for loans to a private trade or business. Qualified Redevelopment Bonds are classified as "non-essential function" bonds.	NAHRO's position is that TIF and tax allocation bonds are public purpose, governmental bonds. As such, they should remain eligible for tax-exemption and not be subject to a state volume cap. TIF and tax allocation bonds should be classified as "essential function" bonds.
	Title XV, Section 1569(c)(5), p.1278	
	B. Effective Dates: TIF bonds issued before Janaury 1, 1986, would be tax-exempt and not subject to new qualified Redevelopment Bond Restrictions. The "grandfather" provision excludes the use of TIF for replacement housing.	NAHRO supports the "grandfathering" any tax reform legislation. Local governments should be permitted to complete current TIF projects. NAHRO favors extending the "grandfather" to TIF projects which provide replacement housing for low- and moderate income persons.
	Title VII, Section 703, p.624	
	Qualified Redevelopment Bond provisions (see below) would go into effect January 1, 1986.	NAHRO supports an effective date of January 1, 1987, for new TIF provisions.

Current Law	H.R. 3838	NAHRO Policy
	Title VII, Section 701, "Section 144(d)", p.557	
	C. Definitions: Tax-exempt Qualified Redevelopment Bonds, (non-essential function bonds), for other than public improvements, may be issued subject to the following conditions:	NAHRO supports the retention of tax-exempt TIF bonds subject to the following conditions.
	1. Use in a locally designated "blighted" area for "redevelopment purposes."	1. Use to improve locally-designated redevelopment areas (as defined by state law).
	2. Any increase in real property tax revenues pursuant to redevelopment is dedicated to pay off debt service.	2. Use in conjunction with an established program or plan for an area's redevelopment.
	3. Bonds are issued pursuant to state law authorizing local use in blighted areas and a redevelopment plan adopted prior to date of bonds issue.	3. For issues after December 31, 1986, use in a locally-designed redevelopment area in which private business investment has not resulted or is not expected to result in the fulfillment of an established redevelopment plan or program's goals.
	4. Local designation of blight should take into account: excessive vacant land on which structures were previously located, abandoned or vacant buildings, old buildings, excessive vacancies, substandard structures, and delinquencies in payment of real property taxes.	

FEDERAL TAX POLICY FOR HOUSING AND COMMUNITY REVITALIZATION
Page Fifteen

Current Law	H.R. 3838	NAHRO Policy
	Title VII, Section 701, "Section 144(d)", p.557	
	D. Eligible Uses:	
	1. Acquisition of real property.	NAHRO favors addition of development of replacement housing for low- and moderate-income persons to the list of eligible activities.
	2. Land clearance and preparation, and transfer to nongovernmental persons at fair market value.	
	3. Rehabilitation of property.	NAHRO favors a change to specify transfer at "fair value".
	4. Relocation of occupants from property.	
	(Public improvements are also eligible uses.)	
	E. Size of Eligible Area:	
	1. Areas not to exceed 10% of assessed value of property in a jurisdiction.	NAHRO opposes these size restrictions.
	2. Areas larger than 1/4 square mile.	

FEDERAL TAX POLICY FOR HOUSING AND COMMUNITY REVITALIZATION
Page Sixteen

Current Law	H.R. 3838	NAHRO Policy
	Title VII, Section 701, "Section 144(d)", p.557	
	F. Restrictions:	
	1. Prohibition on redevelopment which includes retail food and beverage, automobile sales and service, or recreation or entertainment facilities.	NAHRO opposes this restriction.
	2. QRBs lose tax-exemption if first purchaser of single family housing in the redevelopment plan is not the occupant or if occupant fails to meet income or purchase price limits specified under Qualified Mortgage Subsidy Bond provisions of H.R. 3838.	NAHRO opposes the housing provisions as overly restrictive. NAHRO supports the use of federal tax incentives for the development of low- and moderate-income housing and the revitalization of physically and economically distressed areas.
	3. QRBs lose tax-exemption if new or rehabilitated rental housing fails to include a set-aside of units to be occupied by low-income households (at least 20% of units by households at 70% of median income or below).	

FEDERAL TAX POLICY FOR HOUSING AND COMMUNITY REVITALIZATION
Page Seventeen

Current Law	H.R. 3838	NAHRO Policy
	Title VII, Section 701, "Section 144(d)", p.557. G. Volume Cap:	
	1. Bond issues fall under state volume cap (if least 10% of proceeds constitutes a use in a private trade or business or 5% constitutes a loan to a person in a private trade or business).	NAHRO opposes placing TIF bonds under a volume cap (NAHRO defines TIF bonds as "essential function" bonds).
	2. For states wherein over $25 million in TIF bonds have been issued between July 18, 1984, and November 21, 1985, $8 per capita or $8 million (the greater thereof) of the state volume cap is set aside for TIF bonds.	
	3. State legislation may override the set-aside.	

FEDERAL TAX POLICY FOR HOUSING AND COMMUNITY REVITALIZATION
Page Eighteen

Current Law	H.R. 3838	NAHRO Policy
X. DEDUCTIBILITY OF STATE AND LOCAL TAXES		
State and local taxes are fully deductible from individual taxes for taxpayers who itemize.	The Committee retains the full deductibility of state and local taxes.	NAHRO supports the Committee's decision.

The CHAIRMAN. Thank you, Mr. Maffin, and I would certainly agree with your last statement. There are a lot of people who are advocating a tax increase as a means of reducing the deficit, and I cannot go along with that, because of the practical results of tax increases since I have been here. Every one of them has been used to increase spending, and I personally will not vote for a tax increase just to fuel more spending and make the problem worse. I will vote for a tax increase, if we can somehow legislatively figure out how to have it apply to reducing the deficit.

Mr. MAFFIN. I share your point.

The CHAIRMAN. Like in 1982 with TEFRA, for every new dollar of revenue, we spent about $1.04 to $1.06, and that generally added to the problem. And from my experience in housing, one of the major problems has always been inflation. That is what has made it more difficult than anything for first-time home buyers, for low- and moderate-income people to get into housing.

NO. 1 ISSUE IS TO CONTROL INFLATION

There's a lot of things we can do that would improve housing, as Mr. Zigas suggests, but I think the No. 1 thing is to keep inflation under control and keep affordable housing. So I am one of those who will be in the woodshed, I suppose, for signing the letter going down to the President to say, "Let's put first things first. Let's take care of fiscal policy first and then worry about tax reform, in order of importance." I think that is the much greater priority.

I would like to see tax simplification and tax reform and a great deal more fairness in the Tax Code, because no one can honestly say that our Internal Revenue Code is fair. It is not. But this particular tax bill, either Treasury I, Treasury II or H.R. 3838, are neither fair, simplification, nor reform. Nobody can convince me that a bill that is nearly 1,400 pages long is simplification, regardless of what it has in it. Even if I agreed with every provision, that is not simplification.

As I said yesterday, it is as if the House hired an interior decorator to rearrange the furniture. Not new furniture, just moved around, put it in different places. And yet most people are in favor of tax reform and simplification, because of the way it is phrased, and I am too. But we certainly haven't reached that at all, and I would hope we would concentrate on doing something about the deficit, find some way to use additional revenue to actually be used to reduce the deficit.

Can you imagine what an 8- or 9-percent mortgage interest rate would do for housing in this country? That would be better than anything else we could possibly do, because I never thought I would live long enough to see us tickled to death with 11 percent mortgage interest rates. When I came to the Senate, I had to give up a 5-percent conventional mortgage for 9 percent here, and I thought that was just terrible, that I was being raped, robbed, and murdered, to have to increase my mortgage this way. Now if we had 9 percent mortgages, can you imagine the new construction that would be going on in this country?

So I agree with you. I think that's our first priority. Mr. Zigas.

Mr. ZIGAS. Senator Garn, if I might just comment on one thing. I think it is important to keep in mind something that we feel very strongly about outside the housing context, and that is that H.R. 3838 does have some major and important changes to the Tax Code that I think are important to keep in mind, particularly as they assist low-income people and assist in the issues you've raised. One is that it does take a large number of very low-income wage earners who, over the last 10 years have been put into the tax system unfairly, and have been bearing a disproportionate share of the tax burden, out of the tax system, and in that nature, in that way, it is a very progressive move. And it is something the Senate ought seriously to consider maintaining.

Similarly, it does take a number of American corporations who were profitable and have been enjoying no tax burden for the last 5 years, and by simply putting a minimum tax on those corporations it puts them back on the tax rolls to pay at least some minimum. This would immediately raise $20 billion to $30 billion to be used for whatever the consensus of the Senate is.

Those two items, however, are very important in the context of the gnashing of teeth and the wringing of hands about all the problems H.R. 3838 presents. They do, in fact, have provisions in there that are important for us to consider in the context of deficit reduction or maintenance of essential social services or whatever we choose to use the income for, and they should not be overlooked or ignored in this discussion about the immediate impacts on housing.

The CHAIRMAN. Well, I would say to you that not every provision of H.R. 3838 is bad, you are correct. But I believe they are so minimal in the whole context of the bill that I'm glad that the Senate Finance Committee is not using that as a base for markup, that they will start from scratch. I think the advantages of H.R. 3838 are far outweighed by the disadvantages. I really do believe that the bill, in its totality, is anti-investment, antihousing, anticapital formation, and therefore, would cause more unemployment and more problems for the very people that you work so hard to represent.

So yes, there are some positive aspects of it, but you have to view the bill as a whole, and I'm surprised that the House would pass that kind of a bill, which I think would have such a negative impact across-the-board.

So hopefully, the Senate can do a better job, but we have to go back to the House for a conference, so I'm not very optimistic that we can get a good bill. And I would like to see true simplification. I'd like to see even less tax brackets than we're talking about. We haven't even begun to remove many of the really unfair loopholes in the Tax Code that favor one group over another. We didn't even scratch the surface with so many of them there.

So I'd like to see a really major overhaul of the Tax Code rather than playing with it the way either H.R. 3838, Treasury I or Treasury II does. Mr. Maffin.

Mr. MAFFIN. Just one comment. Senator, if we can help you find ways to assure that a tax increase is used to reduce the deficit, let us know. We'll be happy to be of some help. Second——

The CHAIRMAN. I would suggest a constitutional amendment limiting the terms of Senators and Congressmen would be one the best ways we could solve many of these problems. [Laughter.]

Mr. MAFFIN. Second, I guess our bottom line is that just as appropriate funds and outlays are used to achieve national purposes and objectives, tax expenditures, when we have them, should be measured by the same kinds of tests. If we have a national goal of good sound, solid economically strong cities and neighborhoods and good housing, it seems to me tax expenditures should meet the test of whether they serve those purposes, just as we ask the budget outlays to do.

That's our essential message.

The CHAIRMAN. Gentlemen, I appreciate your testimony very much. Thank you.

The committee is adjourned.

[Whereupon, at 12:15 p.m., the hearing was adjourned.]

[Response to written questions of Senators Heinz, D'Amato, Mattingly, Proxmire, Riegle, and Sasser with additional material supplied for the record follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM

RICHARD A. GUTHMAN, Jr.

1) Of the proposed changes to tax exempt bonds that were included in HR 3838, which ones do you find most troubling?

A. 1. The most troubling changes to tax exempt bonds in Rosty are those which affect traditional public purpose bonds. Rosty changes the definition of what a traditional public purpose is, defines many municipally-owned and operated facilities as "non-essential," and requires many "essential" facilities to qualify under the state unified volume cap in order to be eligible for tax exempt financing. Moreover, having severely restricted the definition of traditional public purpose, Rosty then imposes a whole new array of federal mandates upon those public purpose bonds that could be issued under the new definition. These restrictions mean that in my state of Georgia no bond of any kind can be issued--that is for schools, prisons, highways, or any other clear, 100 percent public purpose. They mean, moreover, that any violation--at any time over the life of the bonds, no matter how unintentional--would make the bonds retroactively taxable.

2) If the proposed changes were enacted, what would be the effect on low income housing and community development?

A. 2. If Rosty were enacted in its present form, we believe it would undercut the ability of states and local governments to provide low income housing opportunities and community development.

With regard to community development, we are most concerned about proposals to restrict tax increment financing. This means of community development, 100 percent secured by local taxes, is authorized under state statute in 34 states. Its purpose is virtually identical to the federal community development block grant goals and objectives; it is, however, a community development program heretofore wholly independent of federal law and grants.

With regard to other aspects of community development, we are concerned that the effective date has halted the issuance of all private activity bonds, including those for UDAG projects. The use of IDBs in distressed areas is critical to rehabilitation and revitalization, especially in view of pending federal budget proposals affecting UDAG, CDBC, and housing.

In our testimony, we pointed out that the intent of the House with regard to low income housing was admirable. Indeed, it mirrored your publicly expressed concerns that any federal assistance directed to housing should be directed to those most in need.

Unfortunately, we are afraid that the intent cannot translate into reality. We believe that the changes proposed for low income multifamily rental housing will simply mean that developers will no longer find an incentive to build such housing.

3) Under the provisions of HR 3838 local government's use of tax exempt bonds would be severely restricted. What alternatives to tax exempt bonds are available for you to use to fill your housing and community development needs?

A. 3. If Rosty were enacted, municipal alternatives for housing and community development would be limited. Since direct federal funding for these areas is proposed for deeper cuts than any other federal programs, obviously that is not a possibility. Taxing ourselves through tax increment financing is restricted.

It would appear that the only alternatives are to issue taxable bonds, and to increase local taxes and state taxes to pay the higher costs and to make up for the reductions in federal funds and in our own municipal authority.

Raising local tax revenues would be nearly impossible, however, in those places experiencing the greatest housing and community development needs. It would be made considerably more difficult under the proposals to repeal all or part of the deductibility of any state or local taxes. Many municipalities are currently experiencing falling assessments. Many--such as all municipalities in Iowa with populations over 500--are under a state imposed cap on property tax rates. Quite honestly, to the extent the federal government cuts back on direct federal assistance, while at the same time undercutting our own ability to help ourselves, we see virtually no alternatives.

4) Have you faced any problems due to HR 3838's January 1, 1986 effective date for imposing new restrictions on tax exempt bonds? What problems have you faced?

A. 4. As I stated in my testimony, the retroactive effective date has caused enormous problems. It has reduced the issuance of general obligation and revenue bonds by more than 50 percent from a year ago January. In Texas, Ohio, and Georgia, the impact has been particularly severe.

The Georgia constitution prohibits the awarding of any contract until bond proceeds are actually in hand. Rosty requires that at least 5 percent of bond proceeds be spent within 30 days.

In Georgia, it is simple. It cannot be done. The governor was forced to withdraw a general obligation bond exceeding $300 million last month for public schools and prisons. Unless and until there are changes in the bill and the effective date, Georgia and all its municipalities are effectively barred from the municipal bond market.

5) Mortgage rates have come down considerably recently. Is there still a need for tax free mortgage revenue bonds?

A. 5. Mortgage rates have come down, but nowhere as precipitously as federal aid for housing. There is and can be no dispute about how grave the housing affordability problem is.

The Senate Banking Committee took the lead in the Congress six years ago to design mortgage revenue bond legislation to ensure that such bonds were used to provide housing opportunities for those who otherwise had no access to homeownership opportunities and to rehabilitate inner cities.

The needs since then have changed; they have worsened. The committee proposal then, which you supported, was innovative and targeted. It still has our support.

6) There is obviously concern here in Washington that tax exempt bonds have been used to fund projects that did not merit federal assistance. Construction of liquor stores, skyboxes and doctors offices (which have now been prohibited) are examples. How would you suggest that Congress restrict revenue bonds to ensure that they are only used for worthy projects?

A. 6. The Congress has repeatedly restricted municipal bonds over the last five years. It has been a non-stop process. The regulations for new restrictions imposed on bonds since 1976 are still not final in many instances. Thus, we must admit to some confusion as to exactly why this area needs to be revisited once again so soon after the enormous changes in the Deficit Reduction Act of 1984.

There are three ways to attempt to restrict bonds to ensure that they are directed to worthy purposes:

a. One could prescribe exactly under what conditions and for what purposes bonds could be issued. For instance, one could say that non-profit hospital bonds could only be issued if the recipient hospital provided at least a minimum level of indigent health care. Housing bonds already are restricted to comply with considerations of federal public policy.

The National League of Cities worked with some members of the House Ways and Means Committee on such an approach in 1983-4, but it was rejected by a majority of the committee as being "too restrictive!"

b. One could take the opposite approach and say that since Congress could not agree on what was appropriate public policy for bonds issued for facilities which are not publicly owned or operated and set a volume cap. This would mean that each municipality and state would have to sort out priorities under public scrutiny to determine what best reflected public purpose needs in the respective jurisdiction. Senator David Durenberger is working on such an approach to present to the Senate Finance Committee.

c. One could take an approach which combines the two above and inserts a requirement of greater local accountability. That is, an alternative could be drafted that would impose no restrictions of any kind on bonds for traditional public purposes or on bonds which clearly meet an identified public purpose (say multifamily low income rental housing, indigent health care, etc.). But where bonds did not meet such a criteria, they could only be issued if the state or local government made a contribution of its own.

Such a proposal, similar to the Senate Banking Committee's proposal on single-family mortgage revenue bonds in 1980, would force the state or local issuer to be accountable to its own taxpayers in a public arena. Currently, private purpose or pass-through tax exempt bonds impose no costs upon the city, and, indeed, we have experienced instances where a developer or other private party has, in effect, argued that the city should issue bonds--or else that party will simply move to another local jurisdiction more willing to issue. These parties have argued that since the bonds do not cost our cities a dime, we have no excuse for not issuing.

Sincerely,

Richard A. Guthman, Jr.
Member, NLC Advisory Council
Council Member, Atlanta, Georgia

STATE OF UTAH
OFFICE OF THE STATE TREASURER
SALT LAKE CITY, UTAH 84114

EDWARD T. ALTER

LARRY W. RICHARDSON
FRED H. JONES

Response by Edward T. Alter, Utah State Treasurer,
to questions from Senator John Heinz
at the
Committee Hearing of the Senate Committee
on Banking, Housing, and Community Affairs
held
February 6, 1986, Panel 2

1. Q: Of the proposed changes to tax exempt bonds that are included in HR3838, which ones do you find most troubling?

   A: The most troubling aspect of HR3838 is the great harm it does to the principles of federalism. It seriously erodes the constitutional standard of reciprocal immunity from taxation between the states and the federal government. It will define long-standing core functions of state and local government, such as providing clean drinking water and adequate sewer facilities, as "non-essential". Because of the imposition of a restrictive cap, HR3838 will make most bonds in my state for such purposes taxable, despite the fact that they have been voted by the people in a bond election. If reciprocal immunity is dead, my state may feel obligated to tax federal property and the income from federal securities. I have already introduced legislation in our legislature to that effect.

2. Q: Have you faced any problems due to HR3838's January 1, 1986 effective date for imposing new restrictions on tax exempt bonds? What problems have you faced?

   A: We have seen several impacts:

   a. The Utah Housing Finance Agency has deferred a planned single family bond issue because no statutory mechanism has yet been established to allocate the cap imposed upon "non-essential" bonds. The Agency is also unsure whether it can comply with the early issuance requirement, that is, whether it can close 5% of mortgages within 30 days.

   b. Salt Lake County estimates that legal uncertainties surrounding its 1986 tax anticipation notes added at least 30 basis points or $250,000 to their cost.

   c. Several municipal entities, including at least two cities and two school district, have cancelled planned debt financings due to HR3838 uncertainties

3. Q: There is obviously concern here in Washington that tax exempt bonds have been used to fund projects that did not merit federal

assistance. Construction of liquor stores, skyboxes and doctors' offices (which have now been prohibited) are examples. How would you suggest that Congress restrict revenue bonds to ensure taht they are only used for worthy projects?

A: Substantially all of the so-called abuses of IDB's were eliminated by TEFRA or long before. If any perceived abuses remain, they should be dealt with specifically. This bill addresses abuses primarily by destroying tax exempt bonding for everyone, which is exactly what Treasury is pledged to accomplish, one way or another. Don't be fooled by old stories of past IDB abuses, the purpose of the tax exempt bond provisions of ~~their~~ this bill is to gut municipal bonding, period.

4. Q: If the proposed changes in HR3838 were enacted, what would be the effect on low income housing and community development? What important public projects will not be produced?

A: The effect will be devastating on economic revitalization and economic development in Utah. We have the highest internal growth rate of any state in the country, and we must be able to provide infrastructure for new citizens and the new industry that will employ them. We cannot provide for growth without providing sewer and water systems and other infrastructure which this legislation makes taxable, or totally eliminates. Because we have traditionally done three times the volume of bonds for infrastructure which will be permitted under our cap, we will be heavily impacted.

5. Q: Under the provisions of HR3838 local government's use of tax exempt bonds would be severely restricted. What alternatives to tax exempt bonds are available for you to use to fill our housing and community development needs?

A: Funds can always be made available for housing at conventional rates. That has the effect of raising the threshold of affordability which will preclude many families of low to moderate income from ever having their piece of the american dream, their own home.

Infrastructure is already so expensive that it is frequently unaffordable by state and local government without subsidies in addition to tax exemption. Without tax exemption, the infrastructure stock of American will obviously deteriorate at an accellerating pace. At the very time that increased responsibility for infrastructure is being pushed on the states and communities, the tools to deal with the problem are being taken away by HR3838. Capital will also become unavailable from the private sector because this bill kills privatization as well.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM

DAVID HERLINGER

Question 1

Of the proposed changes to tax-exempt bonds that were included in H.R. 3838, which ones do you find most troubling?

Answer

The volume limitations placed on housing bonds, the federally mandated and established income limits placed on the MRB program, the bond related provisions of the alternative minimum tax, and the failure to remove the sunset date from the MRB program are all equally burdensome.

Question 2

Have you faced any problems due to H.R. 3838's January 1, 1986 effective date for imposing new restrictions on tax-exempt bonds? What problems have you faced?

Answer

Quite simply, the state housing finance agencies have been unable to issue bonds.

Question 3

There is obviously concern here in Washington that tax-exempt bonds have been used to fund projects that did not merit federal assistance. Construction of liquor stores, skyboxes and doctors' offices (which have now been prohibited) are examples. How would you suggest that Congress restrict revenue bonds to ensure that they are only used for worthy projects?

Answer

That is as much a philosophical problem as it is a practical one. Assuming that a philosophical decision is reached as to what are meritorious projects, I believe that effective targeting, achieved with the input of the industry involved, is the best way to design a tight, yet nationally workable, program.

Question

If the proposed changes in H.R. 3838 were enacted, what would be the effect on low-income housing and community development? What important public projects will not be produced?

Answer

Virtually all of the housing bond programs would be immediately eliminated. Private sector participation in low- and moderate-income housing would end. Given the dirth of federal funds, this end would be catastrophic.

Question 5

Under the provisions of H.R. 3838 local government's use of tax-exempt bonds would be severely restricted. What alternatives to tax-exempt bonds are available for you to use to fill our housing and community development needs?

Answer

Presently, all other federal housing programs are in the process of being, or are being eliminated. Tax-exempt bonds, and the equity incentives of the tax code, are the only existing alternatives.

ATTACHMENT

IMPACT OF H.R. 3838 ON CY 1986 HOUSING BOND AUTHORITY BY STATE

STATE	(A) TOTAL MRBs AND MF IDBs ISSUED CY 1984 (000,000)	(B) TOTAL MRBs AND MF IDBs ISSUED CY 1985 (000,000)	(C) HOUSING PORTION OF H.R. 3838 (000,000)	(D) INCREASE/ DECREASE FROM CY 1984 (000,000)	(E) INCREASE/ DECREASE FROM CY 1985 (000,000)
ALABAMA	$198	$340	$302	$104	($38)
ALASKA	837	352	85	(752)	(267)
ARIZONA	171	750	239	68	(511)
ARKANSAS	124	290	177	53	(113)
CALIFORNIA	3,830	7,194	1,977	(1,853)	(5,217)
COLORADO	354	438	242	(112)	(196)
CONNECTICUT	300	521	238	(62)	(283)
DELAWARE	82	276	85	3	(191)
DC	100	40	85	(15)	45
FLORIDA	1,067	2,382	852	(215)	(1,530)
GEORGIA	409	841	448	39	(393)
HAWAII	100	84	85	(15)	1
IDAHO	56	45	85	29	40
ILLINOIS	528	1,395	865	337	(530)
INDIANA	225	371	412	187	41
IOWA	240	99	216	(24)	117
KANSAS	240	143	184	(56)	41
KENTUCKY	204	374	279	75	(95)
LOUISIANA	304	391	336	32	(55)
MAINE	108	152	87	(21)	(65)
MARYLAND	663	1,069	329	(334)	(740)
MASSACHUSETTS	317	592	437	120	(155)
MICHIGAN	211	300	682	471	382
MINNESOTA	469	1,725	314	(155)	(1,411)
MISSISSIPPI	220	211	196	(24)	(15)
MISSOURI	415	449	377	(38)	(72)
MONTANA	75	200	85	10	(115)
NEBRASKA	213	217	120	(93)	(97)
NEVADA	263	149	85	(178)	(64)
NEW HAMPSHIRE	72	82	85	13	3
NEW JERSEY	362	684	567	205	(117)
NEW MEXICO	126	290	109	(17)	(181)
NEW YORK	759	1,794	1,334	575	(460)
NORTH CAROLINA	183	304	469	286	165
NORTH DAKOTA	76	39	85	9	46
OHIO	422	427	806	384	379
OKLAHOMA	312	69	248	(64)	179
OREGON	131	1,334	202	71	(1,132)
PENNSYLVANIA	377	594	889	512	295
RHODE ISLAND	233	114	85	(148)	(29)

SOUTH CAROLINA	116	285	251	135	(34)
SOUTH DAKOTA	200	213	85	(115)	(128)
TENNESSEE	415	842	357	(58)	(485)
TEXAS	1,917	1,848	1,228	(689)	(620)
UTAH	251	140	123	(127)	(17)
VERMONT	48	94	85	37	(9)
VIRGINIA	653	868	428	(225)	(440)
WASHINGTON	297	445	331	34	(114)
WEST VIRGINIA	227	206	145	(82)	(61)
WISCONSIN	259	549	358	99	(191)
WYOMING	74	100	85	11	(15)
	1984 est.				
PUERTO RICO AN U.S. TERRITORIES	226	n/a	276	50	276
TOTAL	$20,058	$32,711	$18,537		

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM DAVID HERLINGER

QUESTIONS OF SENATOR D'AMATO

Question 1

Under current law, tax-exempt bonds used for single family housing (Mortgage Revenue Bonds)are under a separate volume cap and have a sunset date of December 31, 1987. Tax-exempt bonds used for multifamily housing are currently not restricted by a volume cap.

The House tax bill puts all "non-essential" tax-exempt bonds in a $175 per capita volume cap except airports, ports, and wharfs. $25 of the cap goes for just non-profit hospitals. This leave $150 for almost all other tax-exempt bonds. This means the future cap is the same size as the present cap except single family and multifamily housing must be squeezed in.

Have you done a state-by-state analysis of the number of housing units that would not be built because of inclusion in the cap?

Answer

While state-by-state data on housing units financed by tax-exempt housing revenue bonds are not available at this time, it is possible to compare proposed authority levels for housing under H.R. 3838 and use of authority in 1984 and 1985.

First, even if all 50% of the housing set-aside proposed in H.R. 3838 is issued in 1986, bond volume would decline by 7.6% from 1984 activity levels and 43.3% from 1985. Also, because the 50% set-aside for housing is subject to erosion by state legislatures, actual declines are likely to be higher.

Second, because a per capita allocation is proposed in H.R. 3838 that would replace the current MRB allocation formula based on single family mortgage originations, and because multifamily IDBs would be placed inside the cap, many states would be capped at levels far below 1984 and 1985 activity levels.

Against 1984 activity levels, state authority for tax-exempt housing bonds in 1986 would fall in 25 states and total $5.5 billion in reduced authority. Against 1985 activity levels, state authority would fall in 38 states and total $16.2 billion in reduced authority. The impact of these reductions on a state-by-state basis are shown on the attachment.

Finally, it is possible to estimate the number of housing units which will not be built nationally as a result of the above change. On the basis of reduced authority alone, the $16.2 billion represents almost 200,000 new homes and rental units, and additional financing for another 115,000 existing units.

Question 2

Mortgage Revenue Bonds are being slated for termination at the end of 1987. The proceeds of these bonds are used to finance mortgages for first-time homeowners of single family residences.

With this funding disappearing, who will step into the breach? Are banks willing to make-up the loss of funds? Is the Money provided by mortgage revenue bonds easily replaced?

Answer

The sunset of the mortgage revenue bond program would create a vacuum that would not easily be filled. The program has filled a void in the homeownership arena that banks and other traditional lenders have been unwilling to fill. The recipients of MRB loans are from the lower end of the income scale of homebuyers. In most cases they would be unable to find affordable financing through conventional means, but would remain renters. This is true in periods of low interest rates, such as we are now in and even truer in periods of high rates, when the spread between MRB mortgages and conventional rates is greater.

Question 3

Under the House bill, multifamily housing bonds would be targeted more directly towards low-income families. However, multifamily housing is considered "non-essential." This vital government function will have to compete under the cap. All non-essential bonds are under the cap except ports, airports, and wharfs. Interestingly, Chicago has a port that needs tax-exempt funding.

Should low-income multifamily housing be considered "non-essential"? Is low-income multifamily housing less essential than a port in Chicago?

Answer

The Council of State Housing Agencies is of the opinion that housing - regardless of its categorization of single family or multifamily, rental or homeownership -is an essential purpose. The three basic necessities of life are food, shelter and clothing. Any federal program that enhances these necessities, as does tax-exempt financing, should be considered an essential purpose.

OTHER TAX-EXEMPT BOND QUESTIONS

Question

Under the House bill, tax-exempt bonds could not be issued if 5% of the proceeds were not spent in 30 days. I know that New York City and the State of Georgia ar3e severely restricted by this proposal. What other jurisdictions are hurt?

Answer

-- Single Family Mortgage Revenue Bonds (MRBs)

For single family MRBs, the 5% requirement is totally unworkable, especially when combined with the stricter targeting requirements contained in H.R. 3838. A single MRB issue of $100 million supports from 2000 to 3000 individual home mortgages through loans made by the issuing agency to private lenders within a stat. As many as 150 lenders may participate in any one bond issue.

30 days is far too short to guarantee that 5% of a single family issue will be spent, e.g. converted into home mortgage loans. Average processing times for new construction home loans, for example, take about 90 days.

Separate from the time needed to complete loan application processing. H.R. 3838 requires that 50% of all bond proceeds be directed to households with incomes under 90% of the greater of state or area median family income. The effect of this requirement in many instances will be to slow down application processing. To illustrate, the Colorado Housing Finance Agency currently targets its single family program by allowing prospective homebuyers to submit their applications during a 30-day period to the agency which then ranks the applications in reverse order according to income prior to the actual processing of applications.

-- Multifamily Industrial Development Bonds (MF IDBs)

The 5% requirement on the multifamily side would only work for single development issues, where short-term construction financing was involved, and where a construction start was imminent and would not be delayed.

Adversely affected would be bond deals involving issuers who provide only permanent financing, well beyond construction start in time, and pool financing where a single bond issue is used to finance more than one rental project.

Question

Mr. Herlinger, you state in your testimony that the H.R. 3838 responsibility targets multifamily housing bonds to low-income persons, but that the alternative minimum tax takes away much of the benefit. Would you explain how this happens?

Answer

the impact of the minimum tax proposal adopted by H.R. 3838 would be twofold. First, the proposed taxation of tax-exempt interest would drastically reduce the value of tax-exempt bonds. If investors are to be subject to taxation of their bond income, it makes more sense for them to buy taxable bonds which have higher yields.

The limitation placed on the deduction of net losses of a passive investor is also a factor. Much of the investment value of low- and moderate-income housing is loss value. Limiting the loss value will significantly lessen the investment attractiveness of these projects.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM

LEO M. HENIKOFF, M.D.

1) Of the proposed changes to tax exempt bonds that were included in HR 3838, which ones do you find most troubling?

1. The proposed changes to tax-exempt bonds in H.R. 3838 that are most troubling (in order of decreasing priority) are:

   A. Any cap or limit on tax-exempt financing for these 501(c)(3) institutions.

   As I mentioned in my testimony in Illinois the $25 per capita limit for health care and educational institutions would have limited the volume of such tax-exempt offerings to 67% of the actual experience in 1984 and 12% of actual in 1985. In fact, on a national scale, in 1984 31 states exceeded the volume of bond issuances for 501(c)(3) organizations that would have been allowed under the $25 per capita set aside.

   B. The restrictions on advance refunding.

   I commented in my testimony on the necessity of this mechanism for institutional flexibility in rapidly changing times when rigidity can mean failure of a major institution.

   C. Inclusion of interest in the alternative minimum tax calculation.

   This provision would drive up the cost of such "tax-exempt" issues -- perhaps by as much as 150 basis points. It also very well could change the nature of the market for such issues.

   D. Further limitations on arbitrage.

   This limitation would lead to larger issues and greater cost to be passed on to third parties and government.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM

LEO M. HENIKOFF, M.D.

2) Have you faced any problems due to HR 3838's January 1, 1986 effective date for imposing new restrictions on tax exempt bonds? What problems have you faced?

A. The question was asked whether the January 1, 1986, effective date posed problems for our institution. Because of H.R. 3838's January 1, 1986, effective date, Rush-Presbyterian-St. Luke's Medical on December 27, 1985, refinanced its existing $89.0 million tax-exempt commercial paper program with a $102.2 million tax-exempt variable-rate program. The $13.2 million of additional debt was needed to pay issuance costs and meet debt service reserve requirements. The costs of the refinancing totaled $1.23 million.

3) There is obviously concern here in Washington that tax exempt bonds have been used to fund projects that did not merit federal assistance. Construction of liquor stores, skyboxes and doctors' offices (which have now been prohibited) are examples. How would you suggest that Congress restrict revenue bonds to ensure that they are only used for worthy projects?

A. In light of the concern in Washington over the kinds of projects for which tax-exempt bonds have been used, I would suggest simply that use be restricted to those primary functions for which 501(c)(3) designation was granted.

Thank you again for the opportunity both to testify and to respond to the questions of the Committee.

Yours truly,

LMH:jl

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM

WILLIAM A. HOLBY

"1. Of the proposed changes to tax-exempt bonds that were included in HR 3838, which ones do you find most troubling?"

As I have indicated in my testimony, I am quite concerned that the tax bill, in an attempt to increase the tax liability of commercial banks and insurance companies, directly and indirectly requires the payment of federal income taxes on interest earned on municipal bonds. As a result, these financial institutions, which play a vital role in the municipal market, will have a significantly reduced interest in the acquisition of tax-exempt bonds, with an extraordinarily costly effect on the ability of state and local governments to raise capital to meet essential public needs. While various analysts have attempted to quantify the actual impact on the municipal market, the impact clearly can be expected to be very substantial.

Beyond this particular concern, the National Association of Bond Lawyers has attempted to be specific and constructive in its criticism of H.R. 3838. Apart from the consideration described above, there are seven other matters that NABL has addressed in a series of recommendations submitted to Senator Packwood. Those recommendations generally address the following items:

(1) The use of two groupings for all tax-exempt bonds -- "essential" and "nonessential" -- is extremely troublesome, imposing upon bonds issued to finance traditional governmental purposes many onerous restrictions.

(2) The unified volume cap upon all "nonessential" bonds is inadequate.

(3) Needlessly rigid rules are introduced prohibiting incidental uses of bond proceeds.

(4) Numerous inapplicable or unworkable restrictions are placed upon the broad category of nonessential function bonds.

(5) Inappropriately, the advance refundings of both essential and nonessential function bonds are severely restricted or eliminated altogether.

(6) Inordinate administrative complexities are introduced in an effort to eliminate arbitrage motivated transactions.

(7) Perhaps the most unwanted, unworkable and complicating features of the Bill relate to the extraordinary arbitrage provisions.

"2. Have you faced any problems due to HR 3838's January 1, 1986 effective date for imposing new restrictions on tax-exempt bonds? What problems have you faced?"

It is well known that the issuance by the State of Georgia of approximately $400,000,000 in general obligation bonds, for purely traditional public purposes, is being delayed due to the restrictive provisions of H.R. 3838, including specifically the "5%/30-day rule". The State of Georgia simply is not able to comply with H.R. 3838 in this respect. This particular example very likely is indicative of similar problems being faced by other states, counties and cities.

"3. . . . How would you suggest that Congress restrict revenue bonds to ensure that they are only used for worthy projects?"

In 1982 and in 1984, Congress severely limited the nature of the projects that can be financed with tax-exempt bonds. Clearly, abuses existed in the industrial development bond area, and Congress moved quickly to address those abuses.

Perhaps additional abuses remain even today, although far less publicity is being given to such matters than there has been in the past. In any event, I would suggest that Congress address specific aspects of Section 103 of the Internal Revenue Code that are perceived to permit abuse, rather than altering the issuance of tax-exempt bonds dramatically by categorizing all bonds as either essential or nonessential. Particularly in defining what is an "essential" purpose, I believe it to be inappropriate for the federal government to establish national standards. What is essential and needed in order to promote the best interests of the State of Utah will be far different than what is needed for the State of New York or the State of Georgia.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM

WILLIAM A. HOLBY

> ". . . apart from effective date problems, will H.R. 3838 make it more difficult for bond counsel to issue opinions about the tax-exempt status of municipal bonds?"

Unquestionably, yes. We have addressed in our testimony various provisions of the Bill which we can read and attempt to understand; a substantial amount of the Bill, however, is extremely difficult to interpret. Entirely new concepts and terms are introduced in the municipal finance area which have no relevance to current concepts and which lack clear definition. Furthermore, there are instances of inconsistencies between the Committee Report and the Tax Bill itself. In general, the ability of the Bond Counsel to assure that the bonds are legal, valid, binding and enforceable obligations of the issuer, and that the interest on those bonds is exempt from federal income taxation, is complicated inordinately by the difficulty presented in understanding and interpreting the Bill as presently drafted.

[In the next group of questions from Senator D'Amato, there were four questions related specifically to those members of Panels 2 and 3 who were addressing housing matters. The remaining questions from Senator D'Amato, labeled "Other Tax-Exempt Bond Questions" primarily requested specific factual information relating to jurisdictions that might be affected by H.R. 3838, and relating to the actual impact (quantified in percentage points) that H.R. 3838 would have on the municipal market; I do not have the resources to respond to these questions.]

With respect to question number 3, however, I would respond as follows:

"3. 'Non-essential' tax-exempt bond interest is included in a new minimum tax under the House Bill. Is it constitutional to include tax-exempt interest in a federal minimum tax?"

Constitutional challenges currently are pending with respect to aspects of prior tax bills in which the federal government has regulated the issuance of municipal bonds by state and local governments. Certainly, there is a strong argument that the doctrine of intergovernmental immunity should protect state and local government issuers from federal interference with the issuance of bonds for purposes deemed purely public by such governmental bodies. With respect to the alternative minimum tax, and various other provisions of H.R. 3838 which directly and indirectly result in the federal taxation of municipal interest, this constitutional question is brought more directly into focus and, very likely, would be subject to a challenge on constitutional grounds.

RESPONSE TO QUESTIONS OF SENATOR MATTINGLY FROM

WILLIAM A. HOLBY

"1. How will the various provisions of the proposed Tax Bill relating to banks affect the availability of industrial development bond financing for small businesses?"

Most of our testimony has focused upon the ability of states, counties and cities to raise capital for traditional public purposes, in view of the new restrictions placed upon banks and insurance companies which limit their ability to participate in the municipal market. Clearly, these concerns are of the highest national interest.

For a number of years, however, Congress has provided an incentive for businesses to construct new facilities, or to renovate and expand existing facilities, through exempt small issue industrial development bonds. Perhaps the most sympathetic beneficiary of such financings is the small business, which would be unable to finance such facilities but for the availability of tax-exempt financing. Virtually all of such small businesses depend heavily upon their local banks to acquire these bonds; with the proposed restrictions on the interest deduction, however, banks will have no appetite for industrial development bonds. As a result, many small businesses simply will be unable to raise the capital that they need for acquisitions, renovations and expansions that, ultimately, inure to the general good of the entire community.

"2. What has been the response of banks to the proposed legislation during the pendency of the proposed Tax Bill?"

It is my experience that banks have had one of two reactions. Many now are simply unwilling to participate in tax-exempt financing at all, preferring to wait until the "smoke clears" rather than risking possible adverse consequences of retroactively effective tax legislation. As a result, the normal financial decisions of state and local governments and of businesses are being delayed artificially. The only other viable approach for a prudent banking institution is to assure that all possible risks have been identified at the outset of the transaction. For example, commercial banks now require adjustments to the interest rates to be borne by tax-exempt bonds in the event any of the various adverse aspects of the legislation become law retroactively. Obviously, both of these approaches are troublesome to the efficient financing of public projects.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM

XAVIER SUAREZ

Q 1) Of the proposed changes to tax exempt bonds that were included in HR 3838, which ones do you find most troubling?

A 1. The definition of governmental bonds is improperly restrictive. The volume cap on "non-essential" bonds is too low.

Q 2) If the proposed changes were enacted, what would be the effect on low income housing and community development?

A. 2. Low-income housing is a critical need in Miami. HR 3838 would reduce our capacity to meet that need.

We use tax-exempt tax increment financing for community development. This too would be severly cut back.

Q 3) Under the provisions of HR 3838 local government's use of tax exempt bonds would be severely restricted. What alternatives to tax exempt bonds are available for you to use to fill your housing and community development needs?

A. 3. With the cutbacks in federal housing and community development programs, we do not have any alternative for low income housing and concentrated community development in poor neighborhoods. Standard housing for low-income persons requires a subsidy. Our city does not have the fiscal capacity to provide it with our own resources. The low-income people in our urban region are disportionately concentrated in our city. Our tax base is relatively low and our tax effort is high.

Community development means enriched neighborhood improvement in poor neighborhoods. Again our city budget cannot afford this without a subsidy.

Tax-exempt debt financing is a help, but, in fact, we need the tax-exempt financing plus grant programs.

Q 4) Have you faced any problems due to HR 3838's January 1, 1986 effective date for imposing new restrictions on tax exempt bonds? What problems have you faced?

A 4. The January 1, 1986 effective date has closed the market for most tax-exempt financing.

Q 5) Mortgage rates have come down considerably recently. Is there still a need for tax free mortgage revenue bonds?

A 5. The decline in mortgage rates has not been sufficient, when the cost of housing is considered, to make decent housing affordable to low-income persons. The cost of housing has not declined.

Q 6) There is obviously concern here in Washington that tax exempt bonds have been used to fund projects that did not merit federal assistance. Construction of liquor stores, skyboxes and doctors offices (which have now been prohibited) are examples. How would you suggest that Congress restrict revenue bonds to ensure that they are only used for worthy projects?

A 6. First, I do not agree with the concept that the tax-exemption for local government debt is a form of federal assistance. I believe that the nature of our constitutional federal system implies that local debt be exempt

However, I do agree that there have been inappropriate uses of tax-exempt credit, almost totally with small issue industrial development bonds. I believe tax-exempt financing should be used to enable small firms to start operations in distressed areas where they do, in fact, hire the unemployed and low-income persons and contribute to community improvement. Tax-exempt financing for facilities of large companies in prosperous areas, is, indeed, an abuse of public credit.

The existing volume limits do force local governments to make choices and allocate the credit. Congress could go further and limit the use of the bonds to distressed areas, or for facilities that serve distressed areas. (The factory does not have to be in the middle of neighborhood.)

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM

RICHARD F. KEZER

(1) Of the proposed changes to tax-exempt bonds that were included in H.R. 3838, which ones do you find most troubling?

There are so many changes affecting tax-exempt bonds in H.R. 3838 that it is difficult to identify some as "most troubling." Furthermore, the insidious impact of the bill will come about both through its individual provisions and through their interaction. This is truly a case of the whole being larger than the sum of its parts. I will respond generally:

We are troubled by the changes which would restrict drastically the volume of tax-exempt issuance below any recent measure of need as defined by states and localities. The de-authorization of some exempt activities in current law, the pejorative designation of others as so-called "non-essential" functions and the placement of these financings--as well as portions of general obligation and traditional revenue bonds--under a very restrictive state cap are the principal examples in H.R. 3838 of volume reductions. We are of the opinion that H.R. 3838 would reduce tax-exempt volume by one third to 40%. The projects which do not fit within the cap will either be financed at taxable rates (increasing borrowing costs by about a third) or will not be financed at all.

Also extremely troubling are the host of changes which are already making the issuance of tax-exempt bonds vastly more difficult and costly to states and localities while at the same time raising little or no revenue for the Federal Government. I include in this category such changes as the "early issuance" restrictions; the penalty of retroactive loss of tax-exemptions for failure to comply with complex new arbitrage requirements; unrealistic restrictions on advance refunding; new reporting requirements; the inclusion of interest on "non-essential function" bonds in the alternative minimum tax; the loss of banks' deductibility of carrying costs for tax-exempt bond portfolios; and the imposition of new taxes on tax-exempt interest income earned by property and casualty insurance companies.

The staff of the Joint Committee on Taxation (JTC) have estimated no Federal revenue gain from many of these components. The estimated revenue gain for the rest, while relatively small, is overstated in our view. The attached study prepared by Coopers & Lybrand explains why the rationale for the estimates is incorrect. In addition, the estimates of increased Federal revenues ignore the even greater increase in financing costs that must be assumed by states and localities.

Also of long term concern are the set of provisions of H.R. 3838 which have the effect of interfering significantly in the prerogatives of state and local governments and the relationship between states and their political subdivisions. States and localities have historically employed a wide range of strategies in determining the most appropriate manner of providing essential services. The means of providing these services would be limited stringently by a number of provisions in H.R. 3838. The most important provisions of this type are: (a reduction of the permissible level) of private involvement from 25% to 10% or $10 million for "use" and to 5% or $5 million for loans; and (a new requirement) that all (even de minimus) private uses be aggregated and included under the cap when $1 million or more is used by a non-governmental person. These provisions limit the scope of action of states and localities even with respect to general obligation and traditional revenue financing by penalizing them for any partnership with the private sector, whether non-profit or profit.

Additionally, the proposals have an effect on the relationship between state and local governments. Cap allocation of tax-exempt bonds--including portions of certain general obligation and traditional revenue bonds--rests ultimately with the state. Thus, one impact of H.R. 3838 will be to require cities, such as Pittsburgh, to request a cap allocation from the Commonwealth of Pennsylvania when financing obvious public purposes such as city hall, parks, schools, etc., to the extent private contracts for "use" aggregate to $1 million or more.

(2) Have you faced any problems due to H.R. 3838's January 1, 1986 effective date for imposing new restrictions on tax-exempt bonds? What problems have you faced?

The market is at a virtual standstill, even after a month and a half of experience with the new provisions. No bonds subject to the cap or the individual minimum tax have yet come to market this year. The few general obligation and traditional revenue bonds that were issued through January sold to investors at rates of interest between 25 and 50 basis points (a basis point is .01 percent) higher than comparable obligations not subject to H.R. 3838 (i.e., 1985 bonds trading in the secondary market).

Among the major reasons for the interest rate penalty associated with 1986 bonds are: (1) uncertainty created by the penalty of retroactive taxability (back to the date of issuance) if the arbitrage provisions in H.R. 3838 are not complied with during the life of a bond issue; (2) the loss of bank participation in the market due to H.R. 3838's disallowing banks the ability to deduct their cost of funds to the extent they purchase tax-exempt bonds and (3) the diminution of property and casualty company participation due to new taxes on their tax-exempt interest income.

(3) There is obviously concern here in Washington that tax-exempt bonds have been used to fund projects that did not merit federal assistance. Construction of liquor stores, skyboxes and doctors' offices (which have now been prohibited) are examples. How would you suggest that Congress restrict revenue bonds to ensure that they are only used for worthy projects?

We are sympathetic with the view that "abuses" in the tax code be eliminated in order to provide Americans with lower marginal tax rates. As you referenced in your question, Congress has enacted legislation to redefine tax-exempt bond programs and eliminate abuse three times in the past five years. If new abuses have developed or if old abusive practices continue to elude prior reforms, they should be addressed. My own view of the best way to do that is to work through the current tax code governing tax-exempt bonds, purpose by purpose, and design changes that address any perceived abuses for that purpose, while permitting the remaining "abuse-free" financing to go forward.

These programs function very well over all and provide our communities with capital for public purpose projects. For example, a hearing by the House Ways and Means Committee in 1985 regarding multi-family rental housing for low and moderate income citizens reaffirmed that tax-exempt bonds programs were operating in a suitable manner. Thus, it seems illogical to disrupt the function of working programs in which little or no "abuse" has been demonstrated.

(4) Under the provisions of H.R. 3838 local government's use of tax-exempt bonds would be severely restricted. What alternatives to tax-exempt bonds are available for you to use to fill our housing and community development needs?

In recent decades, the range of funding sources for housing and community development has included three basic types: a) direct federal assistance; b) tax exempt bonds; and c) direct or indirect state or local expenditures ("indirect" includes real estate tax abatement and various zoning incentives provided by local governments). As you know, federal assistance for housing and community development has been cut back significantly in recent years and is expected to be cut back even further. If tax exempt bonds are also severely restricted, state and local assistance is all that would be left. Many communities are already using their indirect means of stimulating community development (i.e., tax abatement) but find these means alone insufficient in providing housing to low and moderate income families and other community development programs unless combined with additional incentives. With the expected increase in other responsibilities facing state and local governments and the decrease in federal aid for these and other programs, we do not expect direct state and local expenditures for these programs to be increased in any significant way.

Questions From Senator Alfonse D'Amato

(1) Mr. Kezer, how would H.R. 3838, as you mentioned in your testimony, raise the costs of borrowing for state and local governments by $49 billion, while revenue gain to the federal government would be only $3.1 billion?

The attached appendix details how one gets to an estimated $49 billion of increased financing costs to state and local governments through the municipal bond provision of H.R. 3838 from 1986-1990. Because each year the additional costs associated with that year's issuance of bonds is additive, the cost goes up steeply in the later years. For example, by 1996--ten years out--the annual cost to state and local governments is $33.1 billion, and a five-year cost would be $165.5 billion. And, assuming an average fifteen-year life to municipal bonds, the cost peaks in about 2001 at $49.7 billion annually. And so on.

Looking into the future (as we necessarily must), one can legitimately quibble with some of the assumptions used in making such estimates. For example, we believe that the Coopers & Lybrand study (attached) of the Treasury and JTC's increased Federal revenue estimates due to the tax-exempt bond provisions of earlier versions of H.R. 3838 shows that they tend to overestimate increased Federal revenues significantly.*

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*C & L's preliminary discussions with the JTC staff subsequent to the House's passage of H.R. 3838 suggest that the JTC has corrected for one of these flaws in the most recent round of estimates for H.R. 3838, substituting the "new" lower marginal tax rates for the higher 50% in current law.

Similarly, in estimating future state and local costs due to the restriction of tax-exempt issuance, one must make some arbitrary assumptions about how much of the financing denied tax exempt status will go forward on a taxable basis (both the JTC and we assume 100% for the sake of comparability) and how much tax exempt finance would have gone forward in the absence of H.R. 3838 restrictions. (The estimates referenced above and detailed on the appendix assume 1985 volume as a base, which was higher than "normal" due to the rush to market caused by pending tax reform legislation, though arguably not a high estimate for the average of 1986 through 1990. Alternatively, one could use the much more conservative volume for 1984 as a base, producing estimates as much as 30% lower.)

The important thing to understand is the gross relationship between the increased Federal revenues, on one hand, and the increased costs to state and local tax and user-fee payers, on the other. Even using the assumptions most favorable to the Treasury's case, the people paying state and local government taxes and user fees lose out by a factor unimaginably greater than potential gains to the Treasury. That is, the people who must ultimately pay for the increased financing costs attributable to the restriction of tax exempt finance must pay between three and ten times more than the amount the U.S. Treasury gains from these restrictions. That is the basic case for arguing that the municipal bond provisions of H.R. 3838 constitute tax shifting from the Federal to the state and local levels in the guise of "tax reform"--and it's not a very "efficient" shift, either.

(2) Would you explain how the proposed minimum tax would in many instances take away the tax-exemption that H.R. 3838 otherwise preserves?

Certain specific financing projects have been exempted from the caps or from new prohibitions through "transition rules" in H.R. 3838. However, these protected bond issues are nevertheless subject to the proposed minimum alternative tax on individuals and corporations and the increased taxes on banks' and property and casualty insurance companies' municipal bond interest income. (Most of them will also be subject to the arbitrage, "early issuance," and other restrictions contained in H.R. 3838.) Thus, to the extent these individual projects come to market, they may experience interest rates very close to taxable rates. And, because of these higher financing costs, some of the projects may prove uneconomic and never come to market.

(3) Mr. Kezer, you state in your testimony that no municipal bonds subject to the minimum tax under H.R. 3838 -- so-called "non-essential function" bonds --- have been issued thus far this year because of the effective date of January 1, 1986. Does your organization have an estimate of the additional cost of issuing those bonds?

It is difficult to estimate with certainty the impact of those provisions. At present, experts in the industry believe that these bonds will be issued at between 75 to 125 basis points (a basis point is .01 percent) higher than so-called essential function bonds. This is because those bonds are subject to the alternative minimum tax for individuals and corporations.

The added cost to issuers of this interest penalty of between 75 to 125 basis points can be quite expensive. For example, an issuer who must pay 10% interest on his bonds instead of 8 3/4% (a 125 basis point difference) on a $100 million financing will pay $1.25 million in additional debt service each year, or $12.5 million over a 10-year average life of the bonds.

(4) Mr. Kezer, how would a city, as your testimony states, be limited or prevented from using tax-exempt bonds to finance construction of a city hall where such services as the management of a newsstand or cafeteria were provided by the private sector?

The inability of a city to construct a city hall with tax-exempt bonds stems from from the 5 and 10 percent rules, the definitions of "use" and "loan" and the $1 million test. In the context of the bill the term "use" relates to activities such as leases, concessions and management contracts of longer than a year -- for example, those governing a newsstand or an employee cafeteria. Use of municipal buildings by a public broadcasting station or any other non-profit cultural program poses the same problem. Any longer-than-one-year contract to sell output constitutes "use": e.g., scrapmetal (derelict cars), water, surplus, power, energy generated as by-products of waste disposal, or waste per se, as in the sale of hospital refuse to hog farmers. Operating contracts of longer than one year constitutes "use," effectively deterring promising experiments in privitization. From the report language accompanying the bill it appears that the term "use" applies to any activity carried on by a non-governmental person in a different way than can be carried on by the general public, encompassing not only profit making entities but also non-profit entities. The definition of the term "loaned" for purposes of H.R. 3838 appears to be somewhat less broad.

The $1 million rule requires that if greater than $1 million is used by or loaned to a non-governmental entity, the so-called "non-essential" portion of the bond issue must be issued subject to the state volume cap or will be taxable.

In determining the level of non-governmental use, there will no longer be an allowance for nonqualified incidental use of proceeds. This means that all non-governmental uses will be aggregated in determining compliance with the 5 and 10 percent rules, as well as the $1 million rule.

It is clear that the new "use" and "loan" standards in conjunction with the aggregation concept would render potentially taxable financings that have long been considered unquestionably "public purpose." For example, in order to finance a city hall with tax-exempt securities, all the activities within and outside of the building must be examined and their costs aggretated. This includes management of newsstands, management of the cafeteria by an outside firm, janitorial or gardening services provided by an outside vendor and even the use of the auditorium by outsiders. If the aggregate non-governmental use exceeds 10 percent of the bond issue or $10 million the city hall cannot be financed with tax-exempt securities. If that use is between $1 million and $10 million, it is subject to the volume cap, and the allocation must be received from the state capital.

"Use" as defined in H.R. 3838 can be found in such diverse activities as: management of a service area on a turnpike by a petroleum company franchise; use of the local high school auditorium by a traveling not-for-profit theatre company; use of public school classrooms by "extended day" day care; leasing of a municipal stadium by a professional sports team; leasing of a municipal stadium by a private university whether for sports or for graduation exercises; maintenance of street lights by a private company; management (in whole or in part of libraries, museums, zoo, and other cultural institutions by not-for-profit organizations.

(5) Mr. Kezer, what is the rationale of H.R. 3838's prohibition of the use of tax-exempt bonds to finance activities such as the construction of a parking lot for a government building?

We are unsure of the rationale for defining public purpose solely on the basis of the percentage involvement in a project by an entity other than a state or local government. Public purpose in H.R. 3838 is not measured by the benefit that an entity provides to the public -- it simply is a measure of how money is spent. In answer to the question, the fact that a parking facility allows citizens to use a government building is irrelevent in determining the project's public purpose. Rather, public purpose involves the determination of whether a private corporation, pursuant to a long term contract, is managing the facility. Irrespective of whether the same public benefit is provided by public or private management of the facility, tax-exemption is permitted only if the facility is managed by a public entity.

(6) Will the proposed minimum tax affect "essential function bonds" more heavily than "non-essential function" bonds?

The individual or corporate minimum tax applies to investors only in the case of "non-essential function" bonds. However, remember that other provisions of H.R. 3838 affecting all municipal bonds -- the 10% and 5% rules, the arbitrage requirements, the need of a cap allocation or the "non-essential function" portion of any "essential function" bonds, etc. -- pose the risks of complete loss of tax-exemption for "essential function" bonds in the event that any of these rules are violated. (See also the answer to question 8, below.)

(7) What would be the dollar effect of H.R. 3838's restrictions on banks and insurance companies from carrying tax-exempt bonds?

The impact is difficult to predict. However, these restrictions apply to all tax exempt bonds purchased by these entities after January 1, 1986, and will have an adverse effect on all state and local government borrowing costs. This will be particularly true for short maturities where banks have been among the most active investors. In addition, banks are especially active in the purchase of securities of smaller units of government. While a transition rule may alleviate some of the deleterious impact of the proposal on smaller issuers, we expect that smaller units of government will suffer from these provisions to a greater degree than other issuers.

(8) Under the House Bill, there is no longer a distinction between IDB's and General Obligation Bonds. In the future, there will only be essential and non-essential bonds. If more than 10% of the proceeds of tax-exempt bonds are used privately, then the bond is considered "non-essential." If a city issued a G.O. and more than 10% of the proceeds were used privately, then that amount goes into a per capita volume cap.

Have you determined how may General Obligation bonds would be impacted by this proposal?

At this time we do not have a firm analysis regarding the impact of the proposal. However, the question misstates the rule. H.R. 3838 would subject the so-called "non-essential function" portion of a bond issue to the per capita volume cap if and only if non-governmental uses aggregate to $1 million or more. In a market where $100 million and $50 million general obligation and traditional revenue bond issues are common and many jurisdictions routinely engage in management contracts and concessions for incidental services and historic collaboration with charitable entities for cultural and some social service functions, we expect that the "$1 million test" will impact a large proportion of all major issuers and thereby subject the typical large G.O. issuers to the risk of needing an allocation under the state cap for some portion of a typical issue bond.

(9) Under the House Bill, tax-exempt bonds could not be issued if 5% of the proceeds are not spent in 30 days. I know that New York City and the State of Georgia are severely restricted by this proposal. What other jurisdictions are hurt?

The City of Phoenix, Arizona, postponed a tax-exempt lease financing on January 15, 1986 due to insufficient investor interest. Investors were not comfortable with the accompanying legal opinion.

The Texas Water Development Board has suspended all financing plans--including $1.2 billion authorized by Texas voters in November.

School districts that have delayed or cancelled bond issues due to H.R. 3838 include: Blue Valley, Kansas; Middletown, Idaho; Jenks Board of Education in Tulsa County, Oklahoma; DeSoto, Starkville and Greene County, Mississippi. In the first case, the school district was able to go forward with the financing in compliance with the "early issuuance" restriction only by purchasing all of the furniture for the school immediately and then paying to store it somewhere for the duration of a prospective construction period. The last 3 financings would have constucted new kindergarten classrooms for those school districts.

(10) "Non-essential" tax-exempt bond interest is included in a new minimum tax under the House Bill.

Is it constitutional to include tax-exempt interest in a Federal minimum tax?

We fear that with all the attention focused on the size of the federal budget deficit and the need to reform the tax code, too little time and energy have been devoted to the impact of tax reform on Federalism. PSA is very concerned that enactment of the tax-exempt bond provisions in H.R. 3838 would mark the furthest intrusion of the federal government into the spheres more properly left to the states. It is troubling to note that this incursion is occurring at a time when the states are being asked to assume a growing responsibility for providing for the needs of their citizens.

Moreover, the constitutional doctrine of "reciprocal immunity" would render unconstitutional a Federal tax on the interest income on state and local government obligations. The one case decided by the U.S. Supreme Court directly on the issue, Pollock v. Farmers' Loan and Trust Company in 1895, forsquarely held that state and local governments have a right to issue securities that are not subject to federal taxation. A tax, such as the minimum tax in H.R. 3838, would seem to fall within this prohibition.

(11) In percentage points, what would the house tax-exempt bond provisions do to the cost of municipal bonds: Today, does a tax-exempt bond market exist?

Generally, the net impact of all of these provisions is to raise the costs of tax-exempt borrowing by state and local governments. Our answer to Senator Heinz's second question, above, discusses our observations concerning the market for "essential function" bonds so far this year. Our answer to your first question discusses additional costs imposed upon state and local borrowers.

APPENDIX I

Projections for Increased Interest Costs for State and Local Governments for Years 1986-1990
(dollar amounts in millions)

		1986-1990 Increased Costs to States & Localities using 1985 volume 1/	
Eliminated Projects			
Pollution Control Facilities	$ 9,728.7		
Sports and Convention Facilities	$ 1,593.3		
Parking Facilties	$ 523.3		
Other	$ 1,536.2		
	$13,190.5	$ 5,935.5	
Volume Permitted Under Cap Minimum Tax	44,230.0	6,630.0	2/
Bank Deductibility		13,500.0	3/
Amount Issued in Excess of Cap	$47,666.8	21,450.1	
20% of Public Power Volume	$ 3,506.7	1,578.0	4/
40% of Airport Volume	$ 1,311.7	590.3	5/
Total Increase in Interest Cost to State and Local Governments		$49,683.9	

Notes

The Treasury Department employs a methodology for forecasting revenue gains at the Federal level by the loss of tax-exempt bonds. Part of this methodology implicitly presumes (as a matter of policy neither the Treasury Department nor the Joint Committee on Taxation releases its methodology in calculating revenue gain estimates), almost without exception, that any tax-exempt bond that would lose its tax-exempt status would be issued as a fully taxable bond.

1/ We have taken the known bond volume for projects that would either lose tax-exempt status outright, or would exceed the volume caps under H.R. 3838, as being issued in 1986 in the taxable market, and that this volume would be issued every year through 1990. According to Moody's Bond Record, the interest rate spread between fully taxable and tax-exempt securities was 303 basis points for 1985 and 349 basis points for 1984. Our calculations (unless otherwise indicated) employ a conservative estimate of 300 basis points as the interest rate differential.

2/ PSA, based on advice from market participants, has presumed that the minimum tax on the rationed tax-exempt bonds would increase borrowing costs by 100 basis points. See Special Report The House Tax Reform Bill: A Devastating Effect on State and Local Government Finance, George D. Friedlander, First Vice President and Manager of the Municipal Research Department, Smith Barney, Harris Upham & Co., Inc., January 14, 1986. The report estimates that the minimum tax provision, in itself, could cost issuers 75-125 basis points as well as raising constitutional questions and causing enormous confusion in the marketplace.

3/ Citibank has forecasted a potential annual $2.7 billion increase nationally in borrowing costs due to the loss of bank deductibility. This has been used on a national basis, but not on a state-by-state basis. See The Impact of Disallowing Bank Interest Deductions in Carrying Municipal Bonds, Philip J. Fischer, Vice President, Municipal Market Analysis Department, Citibank, N.A., December 2, 1985.

4/ PSA assumes that 20% of all public power issues would be adversely affected by the 10% rule, thus adding to interest costs.

5/ PSA assumes that 40% of airport bond issues would have to be issued on a fully taxable basis, thus adding to interest costs.

PSA has not calculated the increased cost of borrowing that would result from proposals on arbitrage, advanced refunding, and the 10% rule, except for public power.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM

BERNARD TETREAULT
c/o John Murphy

Q. Of the proposed changes to tax exempt bonds that were included in HR 3838, which ones do you find most troubling?

A.
1. Subjecting single and multifamily housing bonds to the volume cap applicable to other IDB uses
2. Imposition of unworkable income limits on recipients of Mortgage Revenue Bond mortgages
3. Confimation of the 1987 "sunset" date for the Mortgage Revenue Bond Program
4. Modifying the definition of multifamily "qualified project period" to 15 years or the term of the bonds with the longest maturity
5. Requiring 5% of an issue's proceeds to be spent in 30 days
6. Requiring all (as opposed to substantially all - 90%) of an issue's proceeds to be used for the exempt purpose
7. Inclusion of IDB interest as a preference item in the minimum tax
8. Capping passive partnership losses and subjecting them to the minimum tax
9. An effective date of January 1, 1986 for the new restrictions
10. Requiring rebate of arbitrage profits to Treasury and prohibiting payment of bond issuance costs from arbitrage
11. Denying bank deductions for the interest cost for acquiring and carrying tax exempt bonds

ALHFA's testimony at the February 6, 1986 Committee hearing provides further detail on each of these concerns.

Q. Have you faced any problems due to HR 3838's January 1, 1986 effective date for imposing new restrictions on tax exempt bonds? What problems have you faced?

A. Because of the uncertainty over what provisions of HR 3838 will finally be enacted and because of the January 1, 1986 effective date, local housing finance agencies have been unable to bring any bond issues to market since December 31, 1985.

Q. There is concern that tax exempt bonds have been used to fund projects that do not merit Federal assistance such as liquor stores, skyboxes and doctor's offices (which have now been prohibited). How would you suggest that Congress restrict revenue bonds to ensure that they are only used for worthy projects?

A. By imposing a public purpose test such as is now applied to multifamily and single family housing bonds. For example multifamily projects funded by the process of tax exempt bonds must reserve 20% (under current law) of the units for those at 80% or less than median income. HR 3838 increases the targeting to either 25% of the units for those at 80% of median or 20% at 70% of median. ALHFA supports this targeting. For single family bonds, those receiving mortgages from the proceeds must be first-time homebuyers and the home's purchase price may not exceed an average purchase price. ALHFA has recommended that Congress codify Congressional intent embodied in the 1984 Tax Law that issuers of single family bonds, to the extent feasible, serve persons of lower income before those of higher income.

Q. If the proposed changes in HR 3838 were enacted, what would be the effect on low income housing and community development? What important public projects will not be produced?

A. If local housing finance agencies could issue bonds under HR 3838 were it law, and there is serious question that they would be able to because of the 5% rule and other restrictions, the biggest problem is with the inclusion of single and multifamily housing bonds in the IDB volume cap.

A recent survey of ALHFA members (50 agencies responding) showed that 55% would see their issuing activity cut 80% or more over their 1985 level of activity. 80% of the respondents said their allocations would fall at least 50% or more below their 1985 level of activity. This will mean that many lower income housing opportunities will be lost. Most local agencies will receive allocations so small as to leave them with virtually no resources to undertake effective programs.

Q. What alternatives to tax exempt bonds are available for you to use to fill our housing and community development needs?

A. Next to none. Budget cuts since 1981 have reduced Federal expenditures for lower income housing by over 65%. The President's FY 87 budget, as did his budget for FY 86, calls for funding no new housing units. This fact makes tax exempt financing about all that is left.

Taxable housing bonds could be issued, but the spread between them and conventional rates is so slight that developers will go conventional rather than agree to the public purpose requirements which local agencies would insist on in return for issuing a taxable bond.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM

BERNARD TETREAULT
c/o John Murphy

Q. Have you done a state-by-state analysis of the number of housing units that would not be built because of inclusion under the cap?

A. We have not done a state-by-state analysis of the number of housing units that would not be built.

We would say, however, that the housing "set aside", if each state in fact guaranteed that housing would get 50%, the total volume would be $18 billion. Total housing bond volume in 1985 was $32.54 billion. Obviously such a dramatic reduction in volume will translate in to a sharp reduction in the number of housing units which would be built.

Q. With the sunset of the Mortgage Revenue Bond Program scheduled to take place in 1987, who will step into the breach?

A. No one. Mortgage Revenue Bonds are aimed at those whom the conventional mortgage market has left behind. They are the struggling, first time homebuyers at the bottom of the ladder, whose income is not sufficient to qualify for a conventional mortgage. Serving them also takes some of the pressure off the rental housing market.

Q. Should Low Income Multifamily housing be considered "non essential"? Is it less essential than a port?

A. Absolutely not. Providing housing for lower income persons has been a priority and essential function of government at both the Federal and local levels since enactment of the Housing Act of 1937. Adequate housing is a basic necessity of life and government has a responsibility to house those who cannot house themselves.

Q. Have we quantified the impact of the House Tax bill on housing including partial loss of the property tax deduction?

A. We have not done so. However, a July 15, 1985 study done for the "Tax Fairness for Housing Coalition" (of which ALHFA is a member) by the Harvard/MIT Joint Center for Housing Studies and Wharton Econometrics indicated that the Administration's proposal (which repeals the deduction of all state and local taxes) would increase the after-tax costs of homeownership approximately 10 - 12% and make it even more difficult for younger renter households to purchase a home, thereby increasing demand for rental housing. The Administration also proposed terminating the single family bond program December 31, 1985.

Q. Have we determined how many general obligation bonds would be impacted by the 10%, $10 million rule for use of proceeds by private persons?

A. No.

Q. What other jurisdictions are hurt by the use of 5% of proceeds in 30 days rule?

A. Issuers of tax exempt housing bonds say it is virtually impossible to meet such a requirment given the nature of the multifamily construction process and the mortgage loan underwriting process. This combined with the uncertainty over other changes in the bill have precluded local housing finance agencies from issuing bonds since January 1, 1986.

Q. Is it constitutional to include tax exempt interest in a Federal minimum tax?

A. We do not believe it is.

Q. In percentage points, what would the House bill's tax-exempt bond provisions do to the cost of municipal bonds?

A. Since no housing bonds have been issued since January 1, 1986, we cannot answer this questions.

Q. In dollar terms, how much of an impact would the volume cap have on local housing finance agencies?

A. Assuming that housing got the full 50% of the cap, which is not at all assured, housing bond volume would drop from a 1985 level of $32.45 billion to $18 billion in 1986 and further drop to $9 billion after 1987 to reflect the sunset of the single family bond program.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM
JOHN KOELEMIJ

Q. (1) What is the number of housing units that would not be built because of the inclusion of MRBs and IDBs in the "nonessential" bond cap?

A.(1) The inclusion of mortgage revenue bonds (MRBs) and multifamily industrial development bonds (IDBs) in the volume cap for "nonessential" bonds is only one of a number of provisions in the House Tax bill that will impact the construction of single and multifamily dwellings. In responding to this question, however, we will address only the impact of the volume cap.

The attached table shows the state-by-state distribution of the loss in housing unit production (single and multifamily) that would result from the House cap. The total loss in tax-exempt housing bond volume (from 1984 levels) would be $6.7 billion, resulting in a new unit production loss of almost 20 thousand units. Three states--California, Mayland and Texas--account for nearly one-half of the production loss and the addition of Alaska and Virginia brings the five-state total to almost two-thirds of the total reduction in starts. (The impacts of the cap would be greater and more broadly distributed if the analysis were based on 1985 levels.)

The overall loss of units financed, of course, would be much larger, totaling almost 138,000 units. Nearly 60 percent of MRB issues finance loans on existing units, however, and about 20 percent of IDB funds are applied in existing projects. In addition, our analysis assumes that about 40,000 single and multifamily housing units that had benefited from tax-exempt funds would be financed from other sources.

The estimate of loss of housing production also is based on the assumption that the housing bond issue limit is split evenly between MRB and IDB issues. If instead, two-thirds of the cap is allocated to single family bonds and the remaining one-third is applied to multifamily issues, (a distribution that is more representative of the historical usage of tax-exempt bonds) the production loss would increase by about 4,000 units. This additional loss results from the tighter restriction of IDB issues, which provide a higher proportion of new units than MRBs and would experience less substitution from other financing sources than the single family bonds.

Q. (2) With MRB funding disappearing, who will step into the breach?

A. (2) The termination of mortgage revenue bonds (MRBs) would represent a serious loss. The MRB program, by providing mortgage loans at interest costs below the prevailing market rate, has opened homeownership to a sizeable number of American families. Many of these first-time home buyers would have been unable to qualify for financing at market rates of interest.

Thrifts, banks and mortgage companies may provide loans to some of these prospective home buyers following the elimination of MRB authority, but many first-time purchasers have incomes that are too low to qualify for market-rate loans at those institutions. Those buyers need the assistance that has been provided by tax-exempt MRBs, and would be unable to purchase a home without this program.

This affordability problem has been made even more serious by the recent move by lenders to make their qualifying guidelines more stringent, particularly for borrowers seeking low-downpayment loans.

Mortgage revenue bonds also have served a counter-cyclical role, providing money for home purchases at times when many mortgage lenders are unable or unwilling to make loans. Elimination of the MRB program would remove this important cushion to economic activity.

Q. (3) Should low-income multifamily housing be considered "non-essential?"

A. (3) The elimination of most direct subsidy housing programs has left IDB financing of multifamily residential projects as the primary source of affordable rental housing for low and moderate income families. Measures to assure decent and affordable housing for American families have a long history at both the federal and state and local levels of government. NAHB believes that multifamily housing bonds that are targeted toward low and moderate income families serve important social and economic needs and therefore have a considerable "public-purpose" element. In that light, IDB financing of multifamily rental housing should be considered "essential" funding and should be removed from the catch-all "non-essential" bond cap. If a limitation of volume is considered appropriate, a separate cap could be established that would reflect more accurately the need for such financing.

Q. (4) Have you quantified the impact of the House tax bill on housing, including partial loss of the property tax deduction? How much will this hurt property values?

A. (4) A floor of 3% on the deduction of state and local taxes would have significant impact on home buying decisions, particularly those of first-time buyers. This is because it effectively reduces the amount of homeowner deductions that actually save taxes by the full amount of the floor.

For example, a married family of 4 with $30,000 in income buying a $75,000 house might have $8,500 in homeowner deductions and $3,000 in other deductions. Under the House bill, he gets a standard deduction of $4,800 and loses $2,000 in exemptions if he becomes an itemizer by buying a home, so the first $6,800 in deductions save no taxes over being a renter and taking the standard deduction. With only $3,000 in non-homeowner deductions, the first $3,800 of the homeowner deduction saves no taxes. Only the last $4,700 does.

If, in addition, state and local taxes equal to 3% of the income are removed, non-homeowner deductions are reduced by $900 and the amount of homeowner deductions saving taxes is reduced by $900.

The big impact would be on the basic decision on becoming a homeowner. The decision to "move-up" to a better home would not be affected, because the additional property taxes would be fully deductible. Thus, most property values would not be significantly affected.

Other tax-exempt bond questions

Q. (1) How many general obligation bonds would be classified as "nonessential" under the House definitions?

A. (1) NAHB has no estimate of how many G.O. bonds, say in 1985, would have failed to meet the "essential" bond test. It should be noted, however, that bonds where (1) more than the lesser of 10 percent or $10 million of bond proceeds are used privately or (2) more than 5 percent or $5 million are used to make loans to a private person or entity are classified as "nonessential", but are not eligible for tax-exempt treatment unless specifically exempted in HR 3838. If a "nonessential" project qualified for tax-exempt financing, then that issue is subject to the state's annual volume limitation, unless it is for an airport or a port project. In addition, any portion of an "essential" bond in excess of $1 million that is deemed nongovernmental also is applied toward the annual state volume limitation. Therefore G.O. bonds may deplete a state's tax-exempt volume limitation even if the issues meet the HR 3838 test for "essential" bonds.

Q. (2) Which jurisdictions are hurt by the House provision that requires 5 percent of the proceeds must be spent in 30 days?

A. (2) The 5-percent-within-30-days spending requirement in the House bill would hamper or even block bond issues in almost all jurisdictions for certain kinds of tax-exempt issues. For most issuers, the rule creates practical and administrative problems. For some municipal projects, it is extremely difficult and possibly impossible to comply with the provision. In addition, some states, Georgia and Texas have been identified so far, have laws that conflict with the 5-percent rule. Georgia would have to amend its constitution in order to issue bonds that comply with HR 3838.

Q. (3) Is it Constitutional to include tax-exempt interest in a new minimum tax under the House bill?

A. (3) This is a question which ultimately would have to be addressed by the Supreme Court, assuming the House bill becomes law. It would appear that treating the interest as a minimum tax preference would be inconsistent with the principle of comity between the States and the Federal Government.

The Supreme Court, in Pollock v. Farmers' Loan and Trust Company, 157 U.S.429 (1895), held that the tax-exemption on interest of State and local goverment bonds is constitutionally protected. However, that case involved debt issued for basic governmental activities as opposed to bonds for so-called "private" activities.

Q. (4) What would the House Tax-Exempt bond Provisions do to the cost of municipal bonds? Today, does a tax-exempt bond market exist?

A. (4) The passage of the House tax-reform package already has had a major impact on the municipal bond market, even though a tax bill has not been signed into law. The House bill has produced a reluctance on the part of investors to purchase new tax-exempt issues and has created confusion and uncertainty among issuers. Activity in the tax-exempt markets has dropped sharply as a result of the January 1, 1986 effective date of the tax-exempt bond provisions in the House bill, which compels bond market participants to treat those provisions as law.

There is considerable doubt over the ability of issuers to comply with certain requirements of the House measure, and the fact that a failure to comply with the provisions at any time would result in the bonds becoming taxable retroactively to the date of issue has produced a risk to investors on post-1985 issues.

New issues of tax-exempt bonds feel sharply in January. Statistics compiled by the Bond Buyer show new issues totaled only $1.5 billion, down from $5.5 billion in January 1985 and $36.6 billion in December 1985. All of the January issues were bonds that clearly fall in the "essential" bond classification and therefore present less risk to investors.

Even for "essential" bonds, investors have demanded higher yields to compensate for the risk associated with 1986 tax-exempt bonds. The spread of rates on new bonds over comparable pre-1986 issues has run 50 basis points and higher. That spread has narrowed in the past several weeks, but the new issue market remains extremely thin with issues limited to bonds for purposes that clearly fall within the H.R. 3838 "essential" definition.

In addition, the fact that interest earned on "nonessential" bonds is treated by the House bill as a preference item included in the calculation of the 25 percent minimum tax for individuals could produce a yield differential between those bonds and "essential" bonds which are not included in the minimum tax calculation. Smith Barney, Harris Upham and Company has estimated that this latter differential could reach 75 to 125 basis points.

[illegible] IMPACT OF HOUSE BOND CAP
ON HOUSING PRODUCTION

STATE	BOND VOLUME LOSS (MILLIONS)	UNIT LOSS
ALABAMA	$47.2	117
ALASKA	$789.5	1959
ARIZONA	$0.0	
ARKANSAS	$18.5	46
CALIFORNIA	$1,914.3	4749
COLORADO	$119.8	297
CONNECTICUT	$81.0	201
DELAWARE	$32.5	81
D.C.	$57.5	143
FLORIDA	[illegible]	[illegible]
GEORGIA	$0.0	0
HAWAII	$57.5	143
IDAHO	$13.5	33
ILLINOIS	$0.0	0
INDIANA	$0.0	
IOWA	$91.9	228
KANSAS	$109.1	271
KENTUCKY	$60.3	150
LOUISIANA	$32.0	79
MAINE	$47.4	117
MARYLAND	[illegible]	[illegible]
MASSACHUSETTS	$18.7	46
MICHIGAN	$0.0	0
MINNESOTA	$122.8	305
MISSISSIPPI	$102.0	253
MISSOURI	$77.8	193
MONTANA	$32.5	81
NEBRASKA	$119.8	297
NEVADA	$179.0	547
NEW HAMPSHIRE	$7.5	19
NEW JERSEY	$48.4	120
NEW MEXICO	$51.6	128
NEW YORK	$0.0	0
NORTH CAROLINA	$0.0	0
NORTH DAKOTA	$30.5	76
OHIO	$0.0	0
OKLAHOMA	$76.2	189
OREGON	$30.2	75
PENNSYLVANIA	$0.0	0
RHODE ISLAND	$137.5	341
SOUTH CAROLINA	$0.0	0
SOUTH DAKOTA	$157.5	391
TENNESSEE	$57.9	401
TEXAS	$901.1	2236
UTAH	$136.3	338
VERMONT	$5.5	14
VIRGINIA	$225.1	1075
WASHINGTON	$9.7	24
WEST VIRGINIA	$128.4	319
WISCONSIN	$61.9	154
WYOMING	$31.5	78
TOTAL	$6,748.5	19796

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO
FROM G. V. BRENNMAN JR.

TAX-EXEMPT BOND QUESTIONS

1. **QUESTION:**

Under current law, tax-exempt bonds used for single family housing (Mortgage Revenue Bonds) are under a separate volume cap and have a sunset date of December 31, 1987. Tax-exempt bonds used for multifamily housing are currently not restricted by a volume cap.

The House tax bill puts all "non-essential" tax-exempt bonds in a $175 per capita volume cap, except airports, ports, and wharfs. $25 of the cap goes for just non-profit hospitals. This leaves $150 for almost all other tax-exempt bonds. This means the future cap is the same size as the present cap, except single family and multifamily housing must be squeezed in.

Have you done a state by state analysis of the number of housing units that would not be built because of inclusion in the cap?

ANSWER:

A state by state analysis of the number of housing units that would not be built due to the cap is being provided to Senator D'Amato by Keith Rasey of the Council of State Housing Agencies. In general, we agree with this data. Our overall conclusion from this data is that 1986 MRB authority is expected to be about half the 1985 level, resulting in about 150,000 fewer MRB financed homes nationwide.

2. **QUESTION:**

Mortgage Revenue Bonds are being slated for termination at the end of 1987. The proceeds of these bonds are used to finance mortgages for first time homeowners of single family residences.

With this funding disappearing, who will step into the breach? Are banks willing to make up the loss of funds? Is the money provided by Mortgage Revenue Bonds easily replaced?

ANSWER:

If the Mortgage Revenue Bond (MRB) program is allowed to sunset at the end of 1987 as scheduled, there will be few, if any, programs to fill the breach. States do not have the funding to enable them to make up the loss of MRB financing and banks have little incentive to offer below-market loans to homebuyers who cannot afford a mortgage at market rates. The federal tax exemption for interest earned by MRB investors is what makes the program work. The tax exemption allows the bond issuers to pay investors a lower-than-market interest rate which means MRB homebuyers are allowed a lower-than-market mortgage rate. There is no substitute for this type of program other than the Mortgage Credit Certificate (MCC) program which is tied to the MRB program.

The irreplaceable value of the Mortgage Revenue Bond program is most evident during periods of high market interest rates. For example, during the 1982-1984 period when interest rates were skyrocketing, the MRB program proved to be the only program able to provide a counter-cyclical effect to high interest rates. In that time, MRBs helped nearly 500,000 families afford a home that otherwise would not be able to do so. Since 1982, almost 800,000 families in all have been helped. This is particularly important in light of the fact that the homeownership rate has been declining in spite of this MRB impact since 1980.

3. QUESTION:

Under the House bill, multifamily housing bonds would be targeted more directly towards low-income families. However, multifamily housing is considered "non-essential." This vital government function will have to compete under the cap. All non-essential bonds are under the cap except ports, airports, and wharfs. Interestingly, Chicago has a port that needs tax-exempt funding.

Should low-income multifamily housing be considered "non-essential"? Is low-income multifamily housing less essential than a port in Chicago?

ANSWER:

Low-income multifamily housing is "essential" when you consider the high priority our country places on adequate and affordable housing for all its citizens.

While the need for ports, airports and wharfs is not insignificant, the need for adequate housing is among the most basic to our society. In light of this, we believe it appropriate and necessary to classify multifamily housing bonds as "essential" and, therefore, outside the volume cap on tax-exempt non-governmental bonds. Under current law, these bonds are outside the volume cap. We believe that they should remain so since the need for low-income multifamily housing is as acute now as ever.

In the District of Columbia, for instance, the vacancy rate on all types of residential rental property is less than 1 percent. Any diminished capacity to issue multifamily housing bonds through volume limitations could have serious repercussions on the D.C. housing market since the District makes significant use of its multifamily housing bond program.

4. QUESTION:

The Finance Committee is considering a 3% floor on the amount of state and local taxes that may be deducted from federal taxes. This means property taxes will be partially limited. This coupled with loss of single family housing bonds will hurt property values.

Have you quantified the impact of the House tax bill on housing including partial loss of the property tax deduction? How much will this hurt property values?

ANSWER:

Our analysis of the impact of H.R. 3838 on owner-occupied housing indicates that it would significantly raise after-tax homeownership costs, resulting in an average potential decline in home values of 8 to 10 percent. Including a 3 percent of AGI floor on property tax deductibility in H.R. 3838 would exacerbate this effect, resulting in an average potential decline in home values of 10 to 13 percent.

The attached table presents impacts of H.R. 3838 with and without the 3 percent of AGI floor on property tax deductibility. For example, due to lower marginal tax rates, the increase in the standard deduction or zero bracket amount, and the provision which disallows $500 of itemized deductions per personal exemption claimed, H.R. 3838 would boost the after-tax cost of owning a $100,000 home by about $1,166 or 12.7 percent. With a 3 percent floor on property tax deductibility, after-tax cost would be increased by about $1,310 or 14.3 percent. Assuming that property values would decline such that after-tax cost would remain the same proportion of disposable income as under current law, the potential declines in property value corresponding to these increases in after-tax cost are 11.0 percent and 12.9 percent, respectively. It is interesting to note that under H.R. 3838 the percentage increase in after-tax cost and percentage decline in value of a $50,000 home is greater than that for a $150,000 home. This is due to the fact that the disallowed itemized deductions of $500 per exemption claimed is a constant dollar amount at all income levels and so has a relatively greater impact as income declines. Moreover, this provision would cause the after-tax cost of a given priced home to increase as family size, and so the number of personal exemptions claimed, increases.

It is important to note that, contrary to what some advocates of tax reform have asserted, a decline of home values due to these proposed changes in tax law would not benefit first-time buyers or current homeowners who would like to upgrade their housing. For example, under current law the annual after-tax cost of a $100,000 home is about $9,200 or about $765 per month. Under H.R. 3838 that after-tax cost would rise to about $10,350 or $865 per month. This increase in after-tax cost is likely to prompt a decline in value such that the after-tax cost under the new tax system would be roughly the same proportion of disposable income as under current law. Thus, the 11 percent decline in value to about $89,000 would cause the after-tax cost to fall back to about $765 per month. The point is that regardless of whether the home costs $100,000 under current law or $89,000 under H.R. 3838, it is still going to cost the homebuyer $765 per month after-tax to own the home.

It is also important to put this potential decline in home values in perspective. Statistics compiled by the Federal Reserve Board indicate that the total stock of owner-occupied homes in this country has a value of roughly $3.5 trillion. An average decline of value of about 8 to 10 percent under H.R. 3838 would represent an aggregate loss of wealth of between $280 billion and $350 billion. The bulk of the net worth of the typical family is the equity they have in their home. Since the average amount of homeowner's equity represents about 70 percent of the home value, the decline in home values would destroy 12 percent to 15 percent of the typical families life savings.

Impact of H.R. 3838 and H.R. 3838 with a 3% Floor on Property Tax Deductibility on After-Tax Homeownership Costs, Federal Tax Burdens and Home Values[1]

	Home Price			
	$50,000	$75,000	$100,000	$150,000
Required Income	$16,000	$24,000	$ 32,000	$ 48,000
Current Law				
After-tax Homeownership Cost	5,078	7,271	9,183	12,436
Homeowner's Federal Tax Burden	386	1,057	1,889	3,786
H.R. 3838				
After-tax Homeownership Cost	5,496	7,895	10,349	13,150
Change from $	+418	+624	+1,166	+714
Current Law %	+8.2%	+8.6%	+12.7%	+5.7%
Homeowner's Federal Tax Burden	283	1,037	1,844	3,279
Change from $	-103	-20	-45	-507
Current Law %	-26.7%	-1.9%	-2.4%	-13.4%
Potential Decline in Home Value	-7.4%	-7.9%	-11.0%	-3.6%
H.R. 3838 with 3% Floor on Property Tax Deductibility				
After-tax Homeownership Cost	5,568	8,003	10,493	13,447
Change from $	+490	+732	+1,310	+1,011
Current Law %	+9.6%	+10.1%	+14.3%	+8.1%
Homeowner's Federal Tax Burden	355	1,145	1,988	3,576
Change from $	-31	+88	+99	-210
Current Law %	-8.0%	+8.3%	+5.2%	-5.5%
Potential Decline in Home Value	-9.3%	-9.8%	-12.9%	-6.9%

Source: NATIONAL ASSOCIATION OF REALTORS®,
Forecasting and Policy Analysis Division

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[1] Example assumes a 20 percent downpayment, a 30-year, fixed-rate mortgage with an 11 percent interest rate, and property taxes equal to 1.31 percent of the home value. Household income assumes that 28 percent of gross income is devoted to principal and interest payments. All tax calculations assume a one-earner family filing a joint return with four exemptions. Current tax law calculations are based on values for personal exemptions, standard deduction or zero bracket amount, and tax brackets for 1986. Tax savings is computed as the difference in tax liability between a homeowner and renter with comparable incomes and comparable amounts of non-housing itemized deductions. The renter's AGI is higher than the homeowner's by the amount of interest income earned on the funds that would be used as a downpayment if the renter were to become a homeowner, assuming those funds yielded 7.5 percent per annum.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM

ROLAND E. POE
c/o Burton C. Wood

HOUSING BONDS

1) UNDER CURRENT LAW, TAX-EXEMPT BONDS USED FOR SINGLE FAMILY HOUSING (MORTGAGE REVENUE BONDS) ARE UNDER A SEPERATE VOLUME CAP AND HAVE A SUNSET DATE OF DECEMBER 31, 1987. TAX-EXEMPT BONDS USED FOR MULTI-FAMILY HOUSING ARE CURRENTLY NOT RESTRICTED BY A VOLUME CAP.

THE HOUSE TAX BILL PUTS ALL "NON-ESSENTIAL" TAX-EXEMPT BONDS IN A $175 PER CAPITA VOLUME CAP EXCEPT AIRPORTS, PORTS, AND WHARFS. $25 OF THE CAP GOES FOR JUST NON-PROFIT HOSPITALS. THIS LEAVES $150 FOR ALMOST ALL OTHER TAX-EXEMPT BONDS. THIS MEANS THE FUTURE CAP IS THE SAME SIZE AS THE PRESENT CAP EXCEPT SINGLE FAMILY AND MULTI-FAMILY HOUSING MUST BE SQUEEZED IN.

HAVE YOU DONE A STATE BY STATE ANALYSIS OF THE NUMBER OF HOUSING UNITS THAT WOULD NOT BE BUILT BECAUSE OF INCLUSION IN THE CAP?

A 1. MBA has not done a state-by-state analysis of the number of housing units that would not be built because of the imposition of the state volume cap on multifamily and single family housing bonds. However, MBA conducted an informal survey of our members last year on the subject of the volume cap. It showed that from their working knowledge in the tax-exempt housing bond business, our members felt there would be an adverse impact in some states, particularly those where the population base was insufficient to correlate with low-income housing needs.

MBA feels the state-by-state volume caps for industrial development bonds (IDBs) proposed in the bill would have a disproportionate and unfair impact on rental housing. If multifamily housing bonds are not excluded from the volume cap, rental housing will have to compete with large scale economic development projects for financing. Smaller rental housing projects, which service the needs of local communities, will have to compete on a state-wide basis with such large projects to their disadvantage. Limiting that financing will seriously impair the development of rental housing necessary to serve the nation's disadvantaged.

2) MORTGAGE REVENUE BONDS ARE BEING SLATED FOR TERMINATION AT THE END OF 1987. THE PROCEEDS OF THESE BONDS ARE USED TO FINANCE MORTGAGES FOR FIRST TIME HOMEOWNERS OF SINGLE FAMILY RESIDENCES.

WITH THIS FUNDING DISAPPEARING, WHO WILL STEP INTO THE BREACH? ARE BANKS WILLING TO MAKE-UP THE LOSS OF FUNDS? IS THE MONEY PROVIDED BY MORTGAGE REVENUE BONDS EASILY REPLACED?

A 2. Mortgage revenue bonds act as a safety valve during periods of high interest rates, particularly for low-income households. During such periods, the private sector is less capable of meeting the needs of low-income families because such families cannot afford the interest rates. It is unlikely the private sector would subsidize homeownership and, therefore, the most severely impacted would be those at whom the mortgage revenue bonds are targeted.

3) UNDER THE HOUSE BILL, MULTI-FAMILY HOUSING BONDS WOULD BE TARGETED MORE DIRECTLY TOWARDS LOW-INCOME FAMILIES. HOWEVER, MULTI-FAMILY HOUSING IS CONSIDERED "NON-ESSENTIAL." THIS VITAL GOVERNMENT FUNCTION WILL HAVE TO COMPETE UNDER THE CAP. ALL NON-ESSENTIAL BONDS ARE UNDER THE CAP EXCEPT PORTS, AIRPORTS, AND WHARFS. INTERESTINGLY, CICHAGO HAS A PORT THAT NEEDS TAX-EXEMPT FUNDING.

SHOULD LOW-INCOME MULTI-FAMILY HOUSING BE CONSIDERED "NON-ESSENTIAL"? IS LOW-INCOME MULTI-FAMILY HOUSING LESS ESSENTIAL THAN A PORT IN CHICAGO?

A. 3. MBA does not apply the definition of "nonessential" to multifamily housing bonds in its testimony.

Previous Congressional mandates have recognized that multifamily housing financed with tax-exempt bonds serves a valid public purpose. The public purpose of a facility should not be defined in terms of who owns it, but rather in terms of who benefits from it. By definition, multifamily housing bonds are not private activity bonds.

The public purpose of multifamily housing was first recognized by the Congress in the National Housing Act of 1934. It was acknowledged by the Congress in the Mortgage Revenue Subsidy Bond Act of 1980 (the "Ullman Bill"), in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), and in the Deficit Reduction Act of 1984 ("DEFRA"). The Ullman Bill required that 20 percent of the units in multifamily housing projects financed with such bonds be reserved for low income tenants, and required that such projects remain rental for an extended period. In essence, Ullman codified the public purpose of such projects. TEFRA, in exempting multifamily housing from the provisions eliminating the utilization of accelerated means of depreciation, again recognized the public purpose of such projects.

In DEFRA, Congress reaffirmed its recognition of the importance of tax-exempt bonds in financing multifamily reisdential rental property for the low income, when it exempted multifamily housing from the state volume limitation and from the rebate requirement of arbitrage profits applied to IDBs, and when it determined that multifamily housing financed with tax exempt bonds should continue to be eligible for full accelerated cost recovery deductions.

4) THE FINANCE COMMITTEE IS CONSIDERING A 3% FLOOR ON THE AMOUNT OF STATE AND LOCAL TAXES THAT MAY BE DEDUCTED FROM FEDERAL TAXES. THIS MEANS PROPERTY TAXES WILL BE PARTIALLY LIMITED. THIS COUPLED WITH LOSS OF SINGLE FAMILY HOUSING BONDS WILL HURT PROPERTY VALUES.

HAVE YOU QUANTIFIED THE IMPACT OF THE HOUSE TAX BILL ON HOUSING INCLUDING PARTIAL LOSS OF THE PROPERTY TAX DEDUCTION? HOW MUCH WILL THIS HURT PROPERTY VALUES?

A 4. MBA has quantified the impact of the House tax bill and of the President's tax proposal on the after-tax cost of homeownership in Exhibits 1, 2, and 3 of our testimony. The after-tax cost would increase under both. Because the President's tax proposal includes full repeal and HR 3838 allows full deductibility, MBA believes that the partial loss of the real property tax deduction would increase the after-tax cost of homeownership more than HR 3838 does, but to a lesser extent than under the President's proposal. The loss in property values would tend, on the average, to correspond with the increase in the after-tax cost of homeownership calculated in the Exhibits.

OTHER TAX-EXEMPT BOND QUESTIONS

1) UNDER THE HOUSE BILL, THERE IS NO LONGER A DISTINCTION BETWEEN IDBs AND GENERAL OBLIGATION BONDS. IN THE FUTURE, THERE WILL ONLY BE ESSENTIAL AND NON-ESSENTIAL BONDS. IF MORE THAN 10% OF THE PROCEEDS OF TAX-EXEMPT BONDS ARE USED PRIVATELY, THEN THE BOND IS CONSIDERED "NON-ESSENTIAL." IF A CITY ISSUED A G.O. AND MORE THAN 10% OF THE PROCEEDS WERE USED PRIVATELY, THEN THAT AMOUNT GOES INTO A PER CAPITA VOLUME CAP.

HAVE YOU DETERMINED HOW MANY GENERAL OBLIGATION BONDS WOULD BE IMPACTED BY THIS PROPOSAL?

A 1. MBA has not determined how many general obligation bonds would be impacted by the 10 percent of proceeds test in HR 3838.

2) UNDER THE HOUSE BILL, TAX-EXEMPT BONDS COULD NOT BE ISSUED IF 5% OF THE PROCEEDS WERE NOT SPENT IN 30 DAYS. I KNOW THAT NEW YORK CITY AND THE STATE OF GEORGIA ARE SEVERLY RESTRICTED BY THIS PROPOSAL. WHAT OTHER JURISDICTIONS ARE HURT?

A 2. MBA does not have information available to determine what jurisdictions would be hurt by the requirement that 5 percent of proceeds be spent within 30 days proposal.

3) "NON-ESSENTIAL" TAX-EXEMPT BOND INTEREST IS INCLUDED IN A NEW MINIMUM TAX UNDER THE HOUSE BILL.

IS IT CONSTITUTIONAL TO INCLUDE TAX-EXEMPT INTEREST IN A FEDERAL MINIMUM TAX?

A. MBA has no position on the issue of the constitutionality of the inclusion of tax exempt interest in a Federal minimum tax.

4) IN PERCENTAGE POINTS, WHAT WOULD THE HOUSE TAX-EXEMPT BOND PROVISIONS DO TO THE COST OF MUNICIPAL BONDS? TODAY, DOES A TAX-EXEMPT BOND MARKET EXIST?

A. MBA has not determined what the impact of HR 3838 would be on the cost of municipal bonds. The Association is aware that the tax-exempt bond market has suffered because of HR 3838.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM

ROLAND F. POE
c/o Burton C. Wood

Q. I am struck by the analysis in your testimony (Exhibits 1-3) that both the President's tax proposal and the House-passed tax bill would significantly increase the cost of homeownership for middle-income families. In recent years young families in particular have had great difficulty in attaining homeownership. Rather than solving that problem, we now seem bent on making the situation worse. I think that's moving in the wrong direction.

What current Federal activities are, in your opinion, most effective in making homeownership more affordable? What additional steps should be taken to help ease the homeownership affordability problem?

A. MBA would respond by first emphasizing the importance of the full deductibility of residential mortgage interest expense and of state and local property taxes. As MBA's testimony more fully develops, the recognition in the tax code of the importance of homeownership encourages and enables millions of Americans to own their own homes.

In addition, the various federal programs, which have been developed over the years to assist homebuyers to obtain mortgage financing, have made homeownership possible. The mortgage insurance programs of the Federal Housing Administration (FHA), and the guaranty programs of the Veterans Administration (VA) and the Government National Mortgage Association (GNMA) should be maintained and strengthened. For instance, wider coverage of adjustable rate mortgages should be authorized for these programs. The government sponsored secondary market instrumentalities, the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC), should be encouraged to experiment with new forms of adding liquidity to the secondary market.

The President's FY 1987 Budget would impose "user fees," "user taxes" in reality, on the FHA, VA, GNMA programs, and on FNMA and FHLMC. These programs and instrumentalities operate at no cost to the taxpayer, except the VA program, which is an entitlement earned by service in the armed forces. In the guise of seeking to reduce the deficit, the Administration would burden the federal mortgage credit assistance programs with crippling fees, in order to reduce their effectiveness. The additional user fees sought by the Administration should be rejected.

Reduction of the federal deficit would ease the affordability of homeownership in the long run, and MBA believes that deficit reduction is an important goal, but deficit reduction should be achieved by spending cuts and, if necessary, broadbased tax increases. Targeted tax increases, such as the proposed additional user fees, should not be adopted.

Finally, two additional current tax issues bear on homeownership. The tax code should continue to allow the use of tax-exempt single- and multifamily revenue bonds when they are targeted toward the disadvantaged, that is, the elderly, the handicapped, and low-income persons. And the tax code should be amended to encourage the use and development of multiple-class mortgage-backed securities.

We appreciate the opportunity to furnish this additional information and stand ready to assist in any other respect.

Sincerely,

Burton C. Wood

BCW:amk

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM
ROBERT SHERMAN

TAX-EXEMPT BOND QUESTIONS FOR PANELS 2 AND 3

HOUSING BONDS

Q.1) UNDER CURRENT LAW, TAX-EXEMPT BONDS USED FOR SINGLE FAMILY HOUSING (MORTGAGE REVENUE BONDS) ARE UNDER A SEPERATE VOLUME CAP AND HAVE A SUNSET DATE OF DECEMBER 31, 1987. TAX-EXEMPT BONDS USED FOR MULTI-FAMILY HOUSING ARE CURRENTLY NOT RESTRICTED BY A VOLUME CAP.

THE HOUSE TAX BILL PUTS ALL "NON-ESSENTIAL" TAX-EXEMPT BONDS IN A $175 PER CAPITA VOLUME CAP EXCEPT AIRPORTS, PORTS, AND WHARFS. $25 OF THE CAP GOES FOR JUST NON-PROFIT HOSPITALS. THIS LEAVES $150 FOR ALMOST ALL OTHER TAX-EXEMPT BONDS. THIS MEANS THE FUTURE CAP IS THE SAME SIZE AS THE PRESENT CAP EXCEPT SINGLE FAMILY AND MULTI-FAMILY HOUSING MUST BE SQUEEZED IN.

HAVE YOU DONE A STATE BY STATE ANALYSIS OF THE NUMBER OF HOUSING UNITS THAT WOULD NOT BE BUILT BECAUSE OF INCLUSION IN THE CAP?

A. 1) In recent years approximately 20 to 25 percent of the multifamily units constructed have used tax-exempt bond financing. The NAA does not have a state-by-state estimate of the reductions in the production of multifamily units that would be caused by volume limitation.

Any estimate of the reduced production should not be limited to volume caps alone. The changes in the depreciation schedules, income requirement and the repeal of other tax incentives for housing will also result in lower production levels. The lost tax incentives for housing combined with the stricter income and unit set-aside qualifications may have a greater impact than the volume limitations.

Q.2) MORTGAGE REVENUE BONDS ARE BEING SLATED FOR TERMINATION AT THE END OF 1987. THE PROCEEDS OF THESE BONDS ARE USED TO FINANCE MORTGAGES FOR FIRST TIME HOMEOWNERS OF SINGLE FAMILY RESIDENCES.

WITH THIS FUNDING DISAPPEARING, WHO WILL STEP INTO THE BREACH? ARE BANKS WILLING TO MAKE-UP THE LOSS OF FUNDS? IS THE MONEY PROVIDED BY MORTGAGE REVENUE BONDS EASILY REPLACED?

A. 2) The country must determine if it wants to give tax benefits for those who need help to own their first home or to those needy individuals who cannot even consider homeownership. Mortgage revenue bonds, the homeownership interest deduction and property tax deduction all help to make homeownership affordable. The present proposals attempt to make rental housing unavailable and unaffordable.

Q. 3) UNDER THE HOUSE BILL, MULTI-FAMILY HOUSING BONDS WOULD BE TARGETED MORE DIRECTLY TOWARDS LOW-INCOME FAMILIES. HOWEVER, MULTI-FAMILY HOUSING IS CONSIDERED "NON-ESSENTIAL." THIS VITAL GOVERNMENT FUNCTION WILL HAVE TO COMPETE UNDER THE CAP. ALL NON-ESSENTIAL BONDS ARE UNDER THE CAP EXCEPT PORTS, AIRPORTS, AND WHARFS. INTERESTINGLY, CICHAGO HAS A PORT THAT NEEDS TAX-EXEMPT FUNDING.

SHOULD LOW-INCOME MULTI-FAMILY HOUSING BE CONSIDERED "NON-ESSENTIAL"? IS LOW-INCOME MULTI-FAMILY HOUSING LESS ESSENTIAL THAN A PORT IN CHICAGO?

A. 3) It is an essential government function to provide housing for those who cannot afford it. Housing is as essential as the construction of ports or roads. The use of housing bonds to assist the low-income renters obtain decent affordable housing is a proper government function.

Q. 4) THE FINANCE COMMITTEE IS CONSIDERING A 3% FLOOR ON THE AMOUNT OF STATE AND LOCAL TAXES THAT MAY BE DEDUCTED FROM FEDERAL TAXES. THIS MEANS PROPERTY TAXES WILL BE PARTIALLY LIMITED. THIS COUPLED WITH LOSS OF SINGLE FAMILY HOUSING BONDS WILL HURT PROPERTY VALUES.

HAVE YOU QUANTIFIED THE IMPACT OF THE HOUSE TAX BILL ON HOUSING INCLUDING PARTIAL LOSS OF THE PROPERTY TAX DEDUCTION? HOW MUCH WILL THIS HURT PROPERTY VALUES?

A. 4) Since the NAA represents only the multihousing industry, neither the three percent floor on the deductibility of taxes or the single-family bond limitations will affect our members.

CHFritts:sm
3/19/86

QUESTION FOR MESSRS. SHERMAN & DRIESLER

Q. In recent decades, thousands of units of low-and-moderate income housing have been built with various forms of federal assistance -- Section 236 and Section 8 being the major ones. The federal tax code has provided large incentives for investing in the development of these units. But now many of those units need additional infusions of cash to keep them marketable, and many of the owners are coming to the end of their legal obligation to make the units available for low-and-moderate income people. Are we in danger of losing a large number of units from the nation's stock of affordable low-and-moderate income housing? How precisely would changes in H.R. 3838 affect our ability to retain decent low-and-moderate income housing?

ANSWER TO SENATOR RIEGLE

A. We have no doubt that H.R. 3838, the Tax Reform Act of 1985, would severely injure our industry. It would force production of rental housing to decline significantly, drive up rents, cause further deterioration of existing housing stock and force the private sector out of the rental housing market. In evaluating the changes proposed, the Administration and Congress are essentially giving notice that decent affordable housing is no longer a national goal. Direct government assistance for housing has virtually been wiped out. Now, the incentives for private industry to produce and maintain existing rental housing would be repealed.

According to statistics, renters represent about 35 percent of all households in America. This translates to approximately 30 million households who choose to rent or find it necessary to rent in order to meet their shelter needs. The typical renter household devotes approximately 30 percent of its income to housing as compared to an owner household that devotes 18 percent of its income to housing and has a median income of $24,400. In 1938, 11 million renter households, or 37.5 percent of renter households, had incomes below $10,000. Their median gross rent as a percentage of income was 56 percent. On average, households with income under $10,000 spent over one-half of their income for housing.

To the extent the tax incentives are repealed, rental income will have to increase to make up the shortfall in the rate of return. Consider the following example -- it is estimated that a married couple with an income of $25,000 would save $100 per year in taxes or $8.00 per month. Assuming market forces would allow for only a ten percent increase in rent on a $350 per month apartment, the increase would be $420 per year or $35 per month. This household's net cash position would be worse, and their tax savings would be absorbed within three months by rent increases. Clearly, tax reform will not benefit this renter household when all the costs and savings are tallied.

With rent levels restricted by the income of the poor and the ability of the upper bracket residents to buy, our industry must operate within narrow boundaries. The rental income plus the expected capital appreciation of the property do not provide an adequate return to investors. The incentives provided by the tax code make the difference when the decision to build or not to build is made. In other words, the tax incentives allow rents to be more affordable. Without tax incentives there will be a halt in multifamily housing construction and rehabilitation. Only those complexes where sufficient rents could be charged would be constructed. Hence, housing for low-and-moderate families will not be built by the private sector unless there is a continuation of federal subsidies. Without the needed incentives in the tax code and limited federal dollars to help subsidize housing for low-and-moderate income individuals, we have no doubt that in the near future there will be a severe shortage of affordable housing for these renters.

CMFisher:sm
3/19/86

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM

STEPHEN D. DRIESLER

HOUSING BONDS

1) UNDER CURRENT LAW, TAX-EXEMPT BONDS USED FOR SINGLE FAMILY HOUSING (MORTGAGE REVENUE BONDS) ARE UNDER A SEPERATE VOLUME CAP AND HAVE A SUNSET DATE OF DECEMBER 31, 1987. TAX-EXEMPT BONDS USED FOR MULTI-FAMILY HOUSING ARE CURRENTLY NOT RESTRICTED BY A VOLUME CAP.

THE HOUSE TAX BILL PUTS ALL "NON-ESSENTIAL" TAX-EXEMPT BONDS IN A $175 PER CAPITA VOLUME CAP EXCEPT AIRPORTS, PORTS, AND WHARFS. $25 OF THE CAP GOES FOR JUST NON-PROFIT HOSPITALS. THIS LEAVES $150 FOR ALMOST ALL OTHER TAX-EXEMPT BONDS. THIS MEANS THE FUTURE CAP IS THE SAME SIZE AS THE PRESENT CAP EXCEPT SINGLE FAMILY AND MULTI-FAMILY HOUSING MUST BE SQUEEZED IN.

HAVE YOU DONE A STATE BY STATE ANALYSIS OF THE NUMBER OF HOUSING UNITS THAT WOULD NOT BE BUILT BECAUSE OF INCLUSION IN THE CAP?

Question 1 - "We have not done a state by state analysis of the number of rental housing units which would not be built because of the cap. It would be difficult to predict this number based on past activity because that is not always an accurate indication of future market demand. In fact often just the opposite is true. In some areas which have a high need for new rental construction (i.e. low vacancy rates) rent controls or other factors could prevent this need from being met even if there were no volume cap."

2) MORTGAGE REVENUE BONDS ARE BEING SLATED FOR TERMINATION AT THE END OF 1987. THE PROCEEDS OF THESE BONDS ARE USED TO FINANCE MORTGAGES FOR FIRST TIME HOMEOWNERS OF SINGLE FAMILY RESIDENCES.

WITH THIS FUNDING DISAPPEARING, WHO WILL STEP INTO THE BREACH? ARE BANKS WILLING TO MAKE-UP THE LOSS OF FUNDS? IS THE MONEY PROVIDED BY MORTGAGE REVENUE BONDS EASILY REPLACED?

Question 2 - "Mortgage revenue bonds, for single family housing, is not an issue the National Multi Housing Council deals with and therefore we would not be able to offer an informed opinion on this question."

3) UNDER THE HOUSE BILL, MULTI-FAMILY HOUSING BONDS WOULD BE TARGETED MORE DIRECTLY TOWARDS LOW-INCOME FAMILIES. HOWEVER, MULTI-FAMILY HOUSING IS CONSIDERED "NON-ESSENTIAL." THIS VITAL GOVERNMENT FUNCTION WILL HAVE TO COMPETE UNDER THE CAP. ALL NON-ESSENTIAL BONDS ARE UNDER THE CAP EXCEPT PORTS, AIRPORTS, AND WHARFS. INTERESTINGLY, CICHAGO HAS A PORT THAT NEEDS TAX-EXEMPT FUNDING.

SHOULD LOW-INCOME MULTI-FAMILY HOUSING BE CONSIDERED "NON-ESSENTIAL"? IS LOW-INCOME MULTI-FAMILY HOUSING LESS ESSENTIAL THAN A PORT IN CHICAGO?

Question 3 - "Multifamily housing bonds should not be considered 'non-essential'. Shelter is one of the basic necessities of life. Providing an adequate supply of decent and affordable housing has been an essential goal of the federal government for over forty years. Now that direct federal programs to accomplish this goal have been all but eliminated, tax exempt bond financing is the only program producing low-income housing in America today. Unless Congress wishes to totally abandon any effort to provide affordable housing to the lower-income segment of our population then tax-exempt bonds for rental housing must be considered an essential use."

4) THE FINANCE COMMITTEE IS CONSIDERING A 3% FLOOR ON THE AMOUNT OF STATE AND LOCAL TAXES THAT MAY BE DEDUCTED FROM FEDERAL TAXES. THIS MEANS PROPERTY TAXES WILL BE PARTIALLY LIMITED. THIS COUPLED WITH LOSS OF SINGLE FAMILY HOUSING BONDS WILL HURT PROPERTY VALUES.

HAVE YOU QUANTIFIED THE IMPACT OF THE HOUSE TAX BILL ON HOUSING INCLUDING PARTIAL LOSS OF THE PROPERTY TAX DEDUCTION? HOW MUCH WILL THIS HURT PROPERTY VALUES?

Question 4 - "The National Multi Housing Council has not taken a position on the deductability of state and local property taxes on an individuals personal residence. However, such taxes are a necessary and legitimate expense of doing business when one is engaged in the business of renting real estate. Therefore, state and local property taxes paid by business should remain fully deductible. If they were not it would no doubt hurt property values, especially in high tax areas. We have not, however, quantified this impact."

OTHER TAX-EXEMPT BOND QUESTIONS

1) UNDER THE HOUSE BILL, THERE IS NO LONGER A DISTINCTION BETWEEN IDBs AND GENERAL OBLIGATION BONDS. IN THE FUTURE, THERE WILL ONLY BE ESSENTIAL AND NON-ESSENTIAL BONDS. IF MORE THAN 10% OF THE PROCEEDS OF TAX-EXEMPT BONDS ARE USED PRIVATELY, THEN THE BOND IS CONSIDERED "NON-ESSENTIAL." IF A CITY ISSUED A G.O. AND MORE THAN 10% OF THE PROCEEDS WERE USED PRIVATELY, THEN THAT AMOUNT GOES INTO A PER CAPITA VOLUME CAP.

HAVE YOU DETERMINED HOW MANY GENERAL OBLIGATION BONDS WOULD BE IMPACTED BY THIS PROPOSAL?

Answers To Other Tax-exempt Bond Questions

1. "The National Multi Housing Council has made no determination as to how many general obligation bonds would be impacted by the 10% proposal. This is not an issue NMHC deals with."

2) UNDER THE HOUSE BILL, TAX-EXEMPT BONDS COULD NOT BE ISSUED IF 5% OF THE PROCEEDS WERE NOT SPENT IN 30 DAYS. I KNOW THAT NEW YORK CITY AND THE STATE OF GEORGIA ARE SEVERLY RESTRICTED BY THIS PROPOSAL. WHAT OTHER JURISDICTIONS ARE HURT?

2. "I am not aware of how any specific jurisdiction might or might not be impacted by the requirement to spend 5% of the proceeds within 30 days."

3) "NON-ESSENTIAL" TAX-EXEMPT BOND INTEREST IS INCLUDED IN A NEW MINIMUM TAX UNDER THE HOUSE BILL.

IS IT CONSTITUTIONAL TO INCLUDE TAX-EXEMPT INTEREST IN A FEDERAL MINIMUM TAX?

3. "It is obviously up to the courts to ultimately decide whether or not including interest from certain forms of state or local tax-exempt bonds in a federal minimum tax is constitutional. However, even assuming for arguments sake such a provision is constitutional, the question which the Congress must decide is whether or not this is good public policy. I submit it is not. If Congress believes a public purpose is being served by encouraging the building of low-income rental housing, hospitals, pollution control and other such facilities, by providing below market interest rates, then putting interest from tax-exempt bonds into the minimum tax undermines that very effort. For example, if a taxpayer is at or near the minimum tax threshold, it can create a situation where the after tax yield on a taxable bond is actully higher than it would be for a tax-exempt rental housing bond. Such a situation would divert investment capital away from the very areas where Congress has decided, for good public policy reasons, to encourace investment. This simply does not make any sense".

4) IN PERCENTAGE POINTS, WHAT WOULD THE HOUSE TAX-EXEMPT BOND PROVISIONS DO TO THE COST OF MUNICIPAL BONDS? TODAY, DOES A TAX-EXEMPT BOND MARKET EXIST?

Question 4 - "There is no market today for newly issued tax-exempt multifamily bonds due to the January 1, 1986 effective date contained in H.R. 3838. Because of the minimum tax provisions, the reduced top marginal rate and several other factors in the House passed tax reform bill the best estimate we can come up with, and it is only an estimate since no housing bonds have been issued under these provisions, is that housing bonds will sell at least 75 to 100 basis points higher than they would absent H.R. 3838."

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM

STEPHEN D. DRIESLER

Q. In recent decades, thousands of units of low and moderate income housing have been built with various forms of Federal assistance---Section 236 and Section 8 being the major ones. The Federal tax code has provided large incentives for investing in the development of these units. But now many of these units need additional infusions of cash to keep them marketable, and many of the owners are coming to the end of their legal obligation to make the units available for lowand moderate income people. Are we in danger of losing a large number of units from the nation's stock of affordable low and moderate income housing? How precisely would changes in H.R. 3838 affect our ability to retain decent low and moderate income housing?

Questions From Senator Riegle "Yes we are in danger of losing a large number of units from the nations low- and moderate-income housing stock should H.R. 3838 be enacted. The specific changes the National Multi Housing Council would recommend to help retain this housing stock are as follows:

1. Depreciation for low- and moderate-income housing must be sufficient to help offset the low rental income which these projects generate. Such depreciation benefit must be greater than other forms of real estate and must be competitive with other asset treatment. Thirty year/200% declining balance is not suffieient. Depreciable lives in the low to mid 20's with acceleration at the 175 to 200% declining balance is not unreasonable considering the additional targeting requirements of H.R. 3838 and top marginal rate reduction.
2. H.R. 3838 provides an exemption from the investment interest limitation of $10,000 plus net investment income per taxpayer for projects which are bond financed. This exemption should be expanded to include all low- and moderate-income housing which meets the tax-exempt bond targeting requirements even if there is no bond financing actually used. This is especially needed if rental housing is kept under a volume cap as in H.R. 3838. This would encourage people to keep certain units set aside for lower-income use but actually cost the Treasury less because there would be no tax-exempt bond financing associated with these units.
3. Low- and moderate-income projects, especially if substantial sums of additional cash are needed for repairs and renovation, often operate at a loss. The passive loss provision of the minimum tax, in H.R. 3838, kills such projects by subjecting these losses to the alternative minimum tax. Any real cash loss should not be subject to any form of tax and a total rental housing exemption should be considered if this provision is not deleted entirely.
4. The ability to arrange creative seller financing also is an important element in making the resyndication of low-and moderate-income housing feasible. Special exemptions from the At-risk, imputed interest and original issue discount rules are needed to accommodate the unique needs of low-income housing."

National Corporation for Housing Partnerships

George M. Brady, Jr.
Chairman

J. Roderick Heller, III
President
Chief Operating Officer

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM
J. RODERICK HELLER, III

February 11, 1986

Senator Jake Garn
United States Senate
Committee on Banking,
Housing & Urban Affairs
Washington, D.C. 20510

Dear Senator Garn:

This responds to your February 7, 1986 questions relating to our testimony given Thursday, February 6.

How would the provisions of the house passed bill in the administrations tax proposal affect single family housing starts.

The National Corporation for Housing Partnerships is primarily a builder of multi-family rental apartments. We accordingly have not analyzed the effect of the various tax proposals on single family housing, except to the degree implicit in the comparison of the benefits provided multi-family housing and single-family housing. As noted in our testimony (attached) the bill clearly discriminates against the renter as opposed to the homeowner.

Do these proposals provide adequate incentives for construction and maintenance of low and moderate income housing?

No, neither the House bill nor the Administration's tax proposal provide adequate incentives for construction or maintenance of low and moderate income rental housing. As set forth in our testimony the loss of accelerated depreciation for real estate, the loss of the deduction for construction period expenses and taxes, and the proposal to pass an alternative minimum tax will make construction or maintenance of rental housing extremely difficult.

In connection with maintenance of low income housing we propose that the House bill and the 1984 Tax Reform Act be amended to permit sellers who currently own property to transfer it to new owners who may be able to better maintain such property. The amendment to the house bill is needed to assure that seller financing, as well as third-party financing, be exempt from the at-risk rules. An amendment to the 1984 Tax Reform Act should exempt seller financing from the provisions of the "matching" requirements that otherwise require an accrual basis taxpayer to deduct interest on a seller purchase money note only to the extent the seller accrues such interest into income.

Questions from Senator Heinz.

Of the proposed changes that affect the production of housing included HR 3838, which ones do you find most troubling?

The failure to exempt low income housing from the retroactive and prospective impact of the alternative minimum tax is most troubling. Regardless of the form of tax incentives that may be made available to low and moderate income housing, application of an alternative minimum tax would effectively wipe out any such gains. In addition, the "chilling" effect presented by inadequate effective dates in HR3838 is causing current transactions to grind to a halt.

Under the provisions of HR 3838 the production of housing will be severly restricted. What alternatives to the traditional housing production methods which would be curtailed by HR 3838 are available to fill our housing needs?

Because HR 3838 makes very few distinctions between low income housing and other kinds of real estate, low income housing will be required to compete with market rate rental apartments and commercial real estate for loan and investment dollars. Because the returns to investors from rental housing are limited (because rents are deliberately kept low to accommodate a less well to do tenant base) on the "level playing field" of real estate, low income housing will be unable to compete at all. Further, because the transfer of existing housing is limited by the 1984 Tax Reform Act and the at-risk rules proposed in HR 3838, existing housing will not be transferable to new owners who have a greater interest in preserving it. Thus, not only are there few realistic available alternatives to current production methods for housing, but there will be disincentives to the transfer and preservation of housing that has already been produced.

The production of low and moderate income housing requires federal assistance in some form. The principal alternative to tax assistance for low and moderate income housing has been direct subsidies, such as made available under the Section 8 and

Section 236 programs. The destruction of such assistance has increased our dependency on the tax code.

I would be pleased to meet with you or your staff to discuss our concern about rental housing's survival in the wake of tax reform.

Very truly yours,

J. Roderick Heller, III
President

cc: Senator John Heinz

RESPONSE OF BARRY ZIGAS TO QUESTIONS FROM SEN. HEINZ

1. **Question:** Of the proposed changes that affect the production of housing included in H.R. 3838, which ones do you find most troubling:

    Answer: First and foremost, we are troubled by the redefinition of "low income housing" in the House bill which characterizes projects in which only 25 percent of the units are rented to low income people as "low income housing". My prepared statement includes suggestions to change H.R. 3838 to more effectively address the needs of low income renters through the adoption of a new class of property more akin to that in current law: Predominantly Low Income Housing.

    A second very troubling aspect of the bill is the inclusion of **all** investment income or losses from Mixed Income or low income housing in the Alternative Minimum Tax. This inclusion effectively negates whatever other positive actions H.R. 3838 provides to facilitate or encourage investment in rental housing for low income people. Such investment must be excluded from the Minimum Tax, particularly after the changes we have suggested to increase the targeting of these tax subsidies are adopted.

    Finally, H.R. 3838's failure to maintain incentives for the continued preservation of the existing stock of low income housing already supported through federal mortgage insurance, tax and direct subsidies is extremely troubling. Over 600,000 units of housing now exists which H.R. 3838 places in extreme jeopardy. My prepared statement suggests ways in which the needs of such housing could be accommodated through the adoption of a Predominantly Low Income Housing classification. Perhaps the single most damaging provision of H.R. 3838 as it now stands in this regard is the provision for exclusion from the at-risk rules only for projects financed through third party, nonrecourse financing. Seller financing plays a major role in the transfer of many existing low income properties. H.R. 3838, if not amended, will foreclose the use of this important tool in such transfers, threatening the continued availability of this irreplaceable housing resource for hundreds of thousands of low income tenants.

2. **Question:** Under the provisions of H.R. 3838 the production of housing will be severely restricted. What alternatives to the traditional housing production methods which would be curtailed by H.R. 3838 are available to fill our housing needs?

    Answer: The Senate should seriously consider the replacement of all the depreciation provisions in H.R. 3838 and current law with a tax credit approach. The use of a tax credit would have several salutary effects on the federal tax subsidy programs for housing. First, a credit is more efficient, providing the same tax benefit to a much broader class of tax payers. Second, the overall costs of providing the credit should be lower. Third, a refundable tax credit, with adequate funding to finance refunds, would enable nonprofit sponsors of low income housing to receive the tax subsidy directly, eliminating the need for costly middlemen or for the marketing of tax shelter schemes to raise sufficient equity to carry out necessary programs. Ownership of such projects could and would remain with the nonprofit.

The practical elimination of any direct subsidies to support rehabilitation or production of low income housing has placed the total burden of encouraging such activities on the tax Code. There is no reasonable alternative to a continued federal role in the financing of low income housing. It would be much more efficient and equitable to finance such assistance directly. But in the absence of such assistance, tax subsidies are essential to maintain any degree at all of low income housing development and preservation.

RESPONSE OF BARRY ZIGAS TO QUESTIONS SUBMITTED BY SEN. RIEGLE

1. **Question:** How would the provisions of the House-passed bill and the Administration's tax proposal affect single-family housing starts?

   Answer: Given the current interest rates and generally healthy single-family housing industry, it isn't likely that the changes proposed in the House would have a significant impact on single-family housing starts. However, if interest rates should increase, the restrictions in the House-passed bill might make it harder for state and local agencies to intervene effectively in that market in the future.

2. **Question:** Do these proposals provide adequate incentives for construction and maintenance of low and moderate income housing?

   Answer: No, they do not. The provisions of H.R. 3838 provide some relief for rental housing development, but these benefits are concentrated on housing which can only most generously be called "Mixed Income Housing". Moreover, the bill provides no support for the continued maintenance and revitalization of what we call "Predominantly Low Income Housing" which is already in the existing inventory and is seriously threatened by the provisions of H.R. 3838. Our prepared statement outlines additional provisions we believe are critical to providing the necessary tax treatment to facilitate these units' continued use as low income housing, and to provide suitable incentives to continue to develop such housing.

Responses to Questions from Senator Heinz: By Robert W. Maffin

(1) Of the proposed changes that affect the production of housing included in H.R. 3838, which ones do you find most troubling?

It is hard to isolate specific provisions of the Tax Act of 1985 that are "most troubling". Most of the Act's treatment of low- and moderate-income housing would work to reduce construction, preservation, and investment in decent, affordable housing. H.R. 3838 preserves, while limiting, certain tax incentives which encourage investment in low- and moderate-income housing. Yet the calculation of the alternative minimum tax would effectively wipe out most of these incentives.

1. Effective date. The January 1, 1986, effective date in the H.R. 3838 has effectively eliminated any market for low- and moderate-income housing bonds. Provisions of H.R. 3838 would raise the cost of raising funds through the bond market to state and local governments. These provisions -- their detail and uncertainty -- have unsettled. bond markets. The few current issuers have had to pay premiums to bond buyers, engage in costly and elaborate legal reviews, and in general, have had to pay a higher price to raise funds for housing programs.

2. Volume cap. H.R. 3838 imposes, for the first time, a volume cap in multifamily housing bonds. The overall cap on so-called "non-essential function bonds" would reduce most states' fund raising activities for single and multifamily housing and the revitalization of physically and economically distressed neighborhoods. It would cause harmful competition in each state for a limited supply of bonds -- pitting pollution control, low-income housing, revitalization, and mortgage revenue bonds against each other.

3. Depreciation schedules. Depreciation schedules for all housing -- but low- and moderate-income multifamily housing in particular -- have been raised to the point at which housing investments under H.R. 3838's rules would become financially questionable. Rental housing typically operates with a negative cash flow in its early years. Investors require tax incentives -- particularly accelerated depreciation, expensing of construction period and investment interest costs, and other incentives for limited partnerships -- to put their money in the low- and moderate-income housing that is needed. NAHRO estimates that 350,000 low- and moderate-income housing units will be required every year until the end of the century. Current tax law results in about 200,000 units of low- and moderate-income rental housing. H.R. 3838 will reduce the flow of capital and investment to low-income housing.

4. Alternative minimum tax. The rules for calculating the alternative minimum tax under H.R. 3838 would nullify tax incentives that encourage investment in housing. Tax-exempt interest, accelerated depreciation, interest costs, and limited partnership investment incentives are recaptured in the calculation of alternative minimum tax.

In general, H.R. 3838 targets the use of these incentives to more low- and moderate-income households while reducing or eliminating the tools that make such investment financially feasible.

(2) Under the provisions of H.R. 3838, the production of housing will be severely restricted. What alternatives to the traditional housing production methods which would be curtailed by H.R. 3838 are available to fill our housing needs?

Outside of tax incentives -- tax exempt bonds, accelerated depreciation, rehab tax credits, etc. -- there are severely limited resources available for the production and preservation of decent, affordable housing. Direct spending for housing has been cut 65% in the federal budget process and is scheduled for even more drastic cuts under Gramm-Rudman-Hollings or the President's budget proposals. State and local government have not been able to make up the difference.

State and local programs rely heavily, also, on the ability to issue tax-exempt bonds to raise funds for low- and moderate-income housing programs. Even if states raise funds through taxable bonds, they may be able to raise the capital, but the cost of the capital will probably by too expensive to produce decent, affordable housing or allow low- and moderate-income households to purchase their own homes.

Non-profit development associations and corporations have made inroads in low- and moderate-income housing construction and preservation. But these organizations depend also on the availability of tax-exempt financing. Under H.R. 3838, non-profit organizations' ability to issue tax-exempt bonds (actually to have state and local authorities issue bonds on behalf of these organizations in many cases) would be severely restricted by the rules on the state-by-state tax-exempt bond volume cap.

Also, non-profits and public entities rely on a combination of housing incentives -- tax-exempt bonds, Section 8 modernization and rent subsidy funds, state and local tax incentives, and investments from limited partnerships. These incentives have been eroded over the recent years and would be even more eroded and, in some cases, eliminated, under H.R. 3838.

Alternatives to these strategies for funding would include direct appropriations from state and local government. Many state and local governments are already making substantial contrubutions. States and localitites are now having to shoulder the burden of federal budget cut-backs in general revenue sharing, Community Development Block Grants, and other funds. They would be further limited by any reduction in the ability of individuals to deduct state and local taxes. State and local government has been increasingly taxed by making up for the declining federal support for community development, economic development, public education, and other programs.

The production of decent, affordable housing requires a combination of direct spending and tax incentives. These tools provide the capacity for state and local governments to fund programs, for non-profits to participate in the housing areas, and for private citizens, limited partnerships, developers, and business to invest in single and multifamily housing.

Responses to Questions from Senator Riegle: By Robert W. Maffin

(1) How would the provisions of the House-passed bill and the Administration's tax proposal affect single family housing starts?

Both H.R. 3838 and the Administration's tax proposal are expected to have negative effects on all housing investment. Econometric analysis by other associations and economic forecasters indicate that these tax proposals would lower the value of single and multifamily housing and reduce the incentive for developers and investors to construct and preserve housing.

Several provisions of the Administration's and House's tax plans would work to decrease construction of single family housing.

1. Tax-exempt bonds. The volume cap on single and multifamily housing bonds would reduce the volume of bonds used to finance the construction and purchase of single family housing and the construction and rehabilitation of multifamily housing.
2. Targeting requirements for single family mortgage revenue bonds. The targeting requirements for MRBs -- 50% to households at or below 90% of median income and no assistance to households above 115% of median income -- are too severe. These limits will result in reduced participation in state and local homeownership assistance programs.
3. Equity incentives. Increased depreciation periods, limiting the expensing of construction period and investment interest, recapturing limited partnership incentives through the calculation of the alternative minimum tax will curtain investment in new single family and multifamily housing. These incentives are more critical for multifamily housing investment -- especially because cash flow for multifamily housing tends to be negative in the early years -- but are likely to reduce single family housing investment also.

(2) Do these proposals provide adequate incentives for construction and maintenance of low- and moderate-income housing?

No, neither H.R. 3838 nor the President's proposals provide adequate incentives or safeguards for low- and moderate-income housing. H.R. 3838 provides more incentives that the President's proposal. Neither are as favorable as current law.

President Reagan's plan eliminates tax-exempt bonds for low- and moderate-income housing, eliminates accelerated depreciation for investments in low- and moderate-income housing, and reduces or eliminates a long list of incentives to encourage private investment and public actions to assure a decent, safe, and affordable home for low- and moderate-income families, elderly persons, and disabled persons.

H.R. 3838 threatens low- and moderate-income housing in several ways.

1. Tax-exempt bonds. H.R. 3838 imposes a cap in the volume of multifamily housing bonds. There is currently no cap. NAHRO estimates the need for new multifamily housing units affordable to low- and moderate-income households at 350,000 per year until the end of the century. Currently, bond-financed multifamily housing -- with set-asides for low-income households -- accounts for about 200,000 units per year.

2. Depreciation and other equity investments. H.R. 3838 lengthens the depreciation period for low-income housing investments, restricts the expensing of construction and other interest payments, and recaptures tax-exempt treatment of housing bonds and tax incentives for limited partnership investment in low-income housing through the alternative minimum tax.

3. Income limits in multifamily housing. H.R. 3838 does not provide for any limit on rents paid by low-income households in bond-financed or tax-incentive-benefitted housing. NAHRO supports capping rents of 30% of income for low-income residents of tax-incentive-assisted housing.

In general, H.R. 3838 requires developers and their state and local agency partners to reserve a higher percentage of units for low-income households than at present while severely reducing -- and in some cases eliminating -- tax incentives which make such investments financially feasible.

2/12/86

AARP

STATEMENT

of the

AMERICAN ASSOCIATION OF RETIRED PERSONS

before the

Senate Committee on Banking, Housing and Urban Affair

on the

Impact of H.R. 3838 on Low Income Housing

February 18, 1986

Introduction

The American Association of Retired Persons (AARP) is the nation's largest membership organization, representing the interests of over 22 million members age 50 and above. The Association appreciates this opportunity to express its views on H.R. 3838, the Tax Reform Act of 1985, and would like to focus its comments on the Act's potential impact on low income housing.

Recently, the Federal Government's response to mounting low income housing needs has been increased reliance on tax incentives to stimulate construction and rehabilitation of such housing. H.R 3838 would curtail the present tax incentives for investment in real estate--particularly some generous preferences--thus improving economic efficiency. However, an unintended consequence of tax reform may be the substantial decline of low income housing investment, worsening the present shortage of affordable low income housing. This scenario is, however, avoidable; AARP urges the Committee to explore the utilization of transition rules and increased targeting to prevent significant disruptions in this vital sector.

Background

About 25 percent of older Americans are renters. The Special Committee on Aging of the United States Senate reports that elderly renters, who are generally poorer than older homeowners, pay a far larger proportion of their income for rent than do the non-elderly. For instance, the median rent of an elderly woman living alone (representing the majority of elderly renter households) consumes nearly half of her income.

A number of forces continue to drive up housing costs. Renters must contend with upward pressures on rents caused by an inadequate supply of low cost rental housing, loss of units through urban redevelopment and "gentrification", and a growing renter population, particularly in urban areas.

For these reasons, federally-subsidized housing programs are essential to older Americans, particularly to low income older renters. At present, about 1.5 million units of federally assisted housing are occupied by elderly households, representing close to 40% of the total number of assisted units. Most of these persons are single older women, and a very high proportion of them are minorities. Still, some two million more older households qualify for assistance and do not receive it.

Since 1981, federal housing policy has undergone dramatic changes. Despite the growing need, the federal government has slowed housing production and reduced its role in housing assistance generally. Direct spending for federally assisted, low income housing has been cut by two-thirds, making housing proportionately the hardest hit component of the federal budget in recent years. Major construction programs have been eliminated and the remaining ones have been greatly reduced. Section 202 Housing for the Elderly and Handicapped, for instance, has declined by about 40 percent from production levels of the 1970's. Federal assistance has shifted almost entirely to the provision of rental subsidies in existing units. Accompanying this shift in approach has been a move to divest the federal government of long-term housing commitments and federally financed properties, such as multi-family and senior housing projects.

Direct subsidies for low income housing production and rental assistance have plummeted from a FY 1981 level of $30.1 billion to a FY 1986 level of less than $10 billion. The Administration has now proposed to eliminate the last vestiges of directly subsidized housing production and make vouchers the sole form of assistance to low income families.

Tax Incentives for Low Income Housing

Given the sharp decline in federal subsidies for low income housing, other options are required to meet the vital needs of low income persons. Tax incentives, while less efficient than direct expenditures, may become the primary means of encouraging the development of low income housing. In the final analysis, the combined effect of tax and budget policy upon low income housing must be considered rather than viewing each in isolation.

H.R. 3838 recognizes the continued and growing need for tax incentives in meeting the nation's low-income housing needs. Favorable depreciation provisions, for example, are retained for the construction and rehabilitation of such housing. However, the preferences may not provide the level of incentives needed to generate interest in low income housing. The crucial issues will be first, how low income housing investments will compare with other investments after tax reform, and second, will low income housing investment activity actually increase the availability and affordability of such housing?

The incentives provided by H.R. 3838 may fall short on these two criteria. It is difficult to predict whether the new provisions will sustain the current level of investor interest in low income housing; this important question will not be answered until after reform provisions are in place. For this reason, transition rules phasing out the current tax incentives would be advisable. Transition rules should be coupled with higher targeting requirements; this would ensure that the tax incentives would benefit greater numbers of low income persons.

Generous tax incentives for projects serving a more highly targeted population than under current law would not produce a significant loss of revenue, and would ensure that the tax expenditure benefits those most in need. As a further means of ensuring that designated low income housing units are affordable, a ceiling on rents in such units of 30 percent of tenant income should be required.

Absent such a ceiling, the revenues foregone by the federal government to provide low-income housing would be wasted as such units would be available, yet unaffordable. A restriction on rents would be consistent with rent restrictions in direct expenditure programs.

AARP urges the Committee to work with the Senate Finance Committee in designing appropriate tax incentives for low income housing development. In light of the severe funding cuts in low income housing programs, changes in tax incentives should not further restrict the availability or affordability of housing for low income persons.

American Federation of Labor and Congress of Industrial Organizations

815 Sixteenth Street, N.W.
Washington, D.C. 20006
(202) 637-5000

EXECUTIVE COUNCIL

LANE KIRKLAND PRESIDENT
THOMAS R. DONAHUE SECRETARY-TREASURER

January 14, 1986

Honorable Jake Garn
Chairman, Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This is in response to your letter of December 18, inviting suggestions as to Sections of H.R. 3838 which would merit attention in oversight hearings that you will hold.

Housing Depreciation

Section 201 would repeal the Accelerated Cost Recovery System and substitute in lieu thereof an Incentive Depreciation System for Tangible Property, including new property life classifications. The new property life periods for depreciation of housing would be longer than the old ones.

The report on H.R. 3838 of the House Ways and Means Committee, in introducing the reasons for such changes, points out that proponents of massive tax benefits for depreciable property have theorized that these benefits would stimulate investment in such property, which in turn would pull the entire economy into more growth.

As a matter of fact, the experience of the past few years suggests that the ACRS tax depreciation benefits distort investment powers and, therefore, represent an impediment to growth. In the case of real property, the tax benefits may be so desirable to developers that they far outweigh market considerations. They stimulate the construction of multifamily housing at rents that the market cannot absorb. For the seven years preceding the 1981 introduction of ACRS, the quarterly national rental housing vacancy rate ranged between 4.8 and 5.7 percent. It began to rise above that range in 1983, reached 6.0 percent in 1984, and rose further to 6.8 percent by the third quarter of 1985. This is not a pattern for sustained high level multifamily residential construction and it reflects the sacrifice of careful market analysis in the rush to capture large, rapid depreciation benefits. At the same time, as noted in the House Ways and Means Committee report, significant inequities result from the amount and concentration of such tax benefits. The House, therefore, provided in H.R. 3838 for generally longer depreciation periods that are more systematically related to service lives. I believe the latter will reduce emphasis on the syndicated, primarily tax benefit-motivated sponsorship and increase more market-oriented construction at rents that can serve middle-income families and sustain a high level of rental housing construction for longer periods.

The H.R. 3838 depreciation classifications for housing also make differentiations to provide an incentive for construction of projects that will provide some low-income housing for which there is, no doubt, a market. Regular multifamily rental housing would have a 30-year, straight-line depreciation schedule. "Low-income" housing would have a 30-year, 200 percent depreciation, allowing faster write-offs in earlier years than for regular housing, and "very low-income" housing would have a 20-year, 200 percent depreciation schedule.

"Low-income housing" would be in a project in which (1) 20 percent or more of the units are occupied by individuals whose income is 70 percent or less of median gross income; or (2) 25 percent of the units are occupied by individuals whose income is 80 percent or less of median gross income.

"Very low-income housing" would be in a project in which 40 percent or more of the units are occupied by individuals whose income is 60 percent or less of median gross income."

Under current circumstances, I believe it is appropriate that developers of "low-income" and "very low-income" housing projects have some reasonable tax advantage over those building regular rental housing. However, in order to serve the intended purpose, there should be limits on the rents that could be charged to "low-income" and "very low-income" tenants, perhaps equal to 25 percent and 30 percent, respectively, of income; or equal to no more than some minor fraction of rents charged to tenants with higher incomes.

As a technical matter, the statutory definitions of "low-income" and "very low-income" tenants should refer to "tenants," rather than "individuals" as occupants, and the "median income" should be identified as median "family" income, or median income of "households," which would include both individuals and families who are tenants. It would also be well to specify whether the geographic frame of reference for the median income is the local area, state or national income distribution. Such revisions would also be in order in Section 142(c) of the Bill.

Minimum Tax Provisions

Among the tax preference items that would be modified for determination of the alternative minimum tax of an individual, in Title V of the Bill, is the treatment of the so-called "non-incentive" depreciation for real property. It should be borne in mind, as pointed out in the House Ways and Means Committee Report, that the alternative minimum taxable income "is generally equal to regular tax adjusted gross income, as increased by certain tax preferences and decreased by the alternative tax itemized deductions. The exemption amount, which is subtracted from alternative minimum taxable income before applying the 20 percent rate, is $40,000 for joint returns, $20,000 for married individuals filing separately, $30,000 for single returns." The modifications of the excess of accelerated over straight-line depreciation in the alternative minimum tax calculation, in light of the limited nature of the minimum tax, would not be so significant an added burden as to discourage marketable rental housing investment.

The general overriding reason for such changes in the minimum tax, as expressed in the House Ways and Means Committee report is worth noting:

> **"With respect to the taxation of individuals, fairness and taxpayer morale have been particularly harmed by the proliferation of tax shelters, whereby individuals with substantial economic incomes in effect purchase tax benefits that are not accompanied by significant economic burdens, and thereby may escape significant tax liability. Although some tax shelters depend upon the availability of tax preferences, many tax shelters exploit inherent structural features of the tax system (e.g., the contrast between allowing current depreciation and interest deductions, on the one hand, and not taxing unrealized appreciation, on the other). An effective minimum tax is necessary to allow the committee to substantially reduce the marginal tax rates applicable to high-income taxpayers without causing an overall percentage tax reduction for this group larger than for the average taxpayer."**

Bearing all of the foregoing in mind, I believe that the modifications to the tax preference items subject to the alternative minimum tax are justifiable, and would not have a significant adverse effect upon rental housing construction.

Sincerely,

Henry B. Schechter, Director
Housing and Monetary Policy

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APTA

American Public Transit Association
1225 Connecticut Avenue, N.W.
Washington, DC 20036
Phone (202) 828-2800

Jack R. Gilstrap
Executive Vice President

Chairman
Warren H. Frank
President
Laurence W. Jackson
Secretary Treasurer
Daniel T. Scannell
Immediate Past Chairman
Joseph Alexander
Immediate Past President
Bernard J. Ford

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Reba Malone, Governing Boards
James L. O'Sullivan, Small Operations
Jerome C. Premo, Government Affairs
Charles Portaluppi, Associate Member at Large
James E. Reading, Marketing
Claude G. Robinson, Associate Members
Linda Shepard, Human Resources
Carmen E. Turner, Rail Transit

February 7, 1986

The Honorable Jake Garn
Chairman
Committee on Banking, Housing and
  Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Garn:

On behalf of the members of the American Public Transit Association, I respectfully request that the enclosed letter from me dated January 15, 1986 be made part of the official record of the Senate Banking, Housing and Urban Affairs Committee hearings on the effect of proposed tax reform on programs under the Committee's jurisdiction.

Thank you for your consideration.

Sincerely,

Jack R. Gilstrap

Enclosure

APTA

American Public Transit Association
1225 Connecticut Avenue, N.W.
Washington, DC 20036
Phone (202)828-2800

R. Gilstrap
utive Vice President

Chairman
Warren H. Frank
President
Laurence W. Jackson
Secretary-Treasurer
Daniel T. Scannell
Immediate Past Chairman
Joseph Alexander
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Jerome C. Premo, Government Affairs
Charles Portalupi, Associate Member-at-Large
James E. Reading, Marketing
Claude G. Robinson, Associate Members
Linda Shepard, Human Resources
Carmen E. Turner, Rail Transit

January 15, 1986

The Honorable Jake Garn
505 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Garn:

The American Public Transit Association welcomes the opportunity, afforded by your January 7, 1986 letter, to identify mass transit-related issues addressed in H.R. 3838, the Tax Reform Act of 1985 as approved by the U.S. House of Representatives last month.

In some cases, APTA's membership has taken a formal position on these issues. In other cases the positions spelled-out below represent our industry's best informal thinking. We felt that it is important that you and your staff have the most comprehensive summary of the issues available.

Our members are concerned primarily with the Administration's recommendation to eliminate the deductibility of all state and local taxes. This is because some 42 percent of support for mass transit comes from non-federal tax sources. Fortunately, the House chose to reject this proposal and to maintain full deductibility of state and local taxes.

Other issues include:

INDUSTRIAL DEVELOPMENT BONDS: The interest on IDBs used to fund mass commuting facilities remains tax exempt in the House bill if the facilities are governmentally owned. We support this essentially status-quo position. However, some APTA members, especially those in fast-growing regions of the country, are concerned with a new limitation on mass transit IDBs imposed by the House bill. In the future, such IDBs would be subject to a single statewide volume cap that would arbitrarily and severly limit their use and effectiveness. At a time when the Reagan Administration is aggressively trying to reduce federal investment in mass transit, we should be expanding, not limiting, creative, alternate methods of financing needed facilities.

SAFE HARBOR LEASING: Since Congress authorized it in 1981, a number of local governments and transit authorities have sold the tax benefits of their newly-acquired buses and trains, a process known as safe harbor leasing. In H.R. 3838, the House preserves safe harbor leasing for transit by exempting mass commuting vehicles from the repeal of the The Accelerated Cost Recovery System for tangible personal property placed in service after 1980. But because the legislation also reduces overall corporate tax rates, the value of the tax shelter afforted by safe harbor leasing would not be worth as much as it is currently. Safe harbor leasing is another valuable, creative financing mechanism available to the mass transit community, and it should be preserved in its current form.

CONTRIBUTIONS IN AID OF CONSTRUCTION: The House has agreed to repeal Section 118(b) of the Internal Revenue Code in which regulated public utilities are permitted to exclude certain capital contributions in aid of construction from their revenues for tax purposes. If enacted into law, the repeal of Section 118(b) could result in dramatic construction cost increases for authorities building and planning new fixed-guideway transit systems. For example, The Washington, D.C. Area Metropolitan Transit Authority (WMATA) estimates that the repeal of Section 118(b) will result in more than $45 million in additional costs over the life of the remaining Metrorail construction program. We urge the Senate to take a close look at the effects of proposed repeal of Section 118(b) during its consideration of tax overhaul legislation.

EMPLOYER-PROVIDED TRANSIT PASSES: The House bill does not address an issue of prime importance to many transit systems and employers in their service areas. Current law permits the value of employer-provided transit passes to be excluded from recipient individuals' income for federal tax purposes, but only up to $15 monthly. This arbitrary ceiling is artifically low and has the effect of placing mass transit at a distinct tax disadvantage with, for example, the benefits of employer-paid automobile parking. The value of such benefits are entirely exempt from the calculation of individuals' income under current law.

It seems to us that a government that on the one hand invests billions annually to encourage the use of mass transit should not on the other hand penalize its citizens for choosing mass transit for commuting purposes. The monthly ceiling clearly needs to be raised, perhaps to $50-$75 monthly, to be competitive with benefits afforded other federally-subsidized forms of transportation.

PRIVATIZATION: As a general observation, we call your attention to a potential contradiction that may exist between provisions of the tax bill which generally have the effect of diminishing the tax-related advantages of private investment in public infrastructure, and the continued strong promotion of private investment in public services and facilities being undertaken by various executive branch agencies.

The Urban Mass Transportation Administration, for example, is developing comprehensive procedures, guidelines and legislative proposals to require expanded private involvement in transit. While some of the specific initiatives undertaken by UMTA should be questioned, we support efforts to more effectively integrate public and private transit services. We agree with Congress's recent pronouncement that the legislative branch needs to be totally involved in a thorough debate of the issue.

To the extent that provisions of H.R. 3838 directly frustrate increased private investment in public facilities and services, there is a need to reconcile the tax bill with current Administration policies on privatization. I would urge you to carefully explore, during your upcoming hearings, the specific effects of the tax provisions as they relate to increasing private investment and involvement in providing public facilities and services.

Those are the principal tax-related issues of concern to our industry. We are eager to provide you with further information and to work closely with you and your staff in addressing these issues in hearings or in making legislative recommendations.

Should you need anything further, please contact me or Chip Bishop, APTA's Director of Government Affairs, at 828-2834.

Sincerely,

Jack R. Gilstrap

STATEMENT OF THE
AMERICAN RETAIL FEDERATION
ON
S.1603 AND S.1922
TO IMPOSE A CEILING ON CREDIT CARD INTEREST RATES

The American Retail Federation (ARF) is taking this opportunity to present for the record its views, comments, and suggestions regarding S.1603 and S.1922. ARF is grateful to the Subcommittee and its staff for this opportunity to make known its views on these important legislative proposals.

Membership in ARF consists of 27 national retail trade associations, 50 state retail associations, the Greater Washingon Board of Trade, as well as corporate members. Through its members, ARF represents more than one million retail establishments.

The majority of retailers represented through the Federation offer or extend consumer credit, most of which is in the form of open end (i.e., revolving) credit. The vast majority of those open end credit plans involve the issuance and use of credit cards. For that reason, ARF is vitally interested in these two bills, and the impact that the passage of either bill would have (1) in general, on the availability of consumer credit to all consumers, including low income consumers; and (2) in particular, on the retail industry.

Both S.1602 and S.1922 would establish ceilings on the rate of finance charge that may be imposed on credit card accounts. Neither bill differentiates between credit cards issued by retailers and those issued by banks and travel and entertainment companies. Of necessity, however, our comments and observations are based upon the collective experience of retailers that issue credit cards for use in connection with open-end credit plans. We cannot speak for banks and other non-retail credit card issuers.

The Retail Industry. The retail industry is based on free, open, and vigorous competition. Every day, retailers compete on the bases of price, quality and selection of merchandise, service, and an almost infinite array of other considerations that influence a consumer's decision to buy a particular product or service from a particular retailer. That competition includes credit terms made available to consumers who use credit. For example, right here in the Washington area, the terms of competing revolving credit plans vary widely. Some plans provide for relatively short-term pay outs, with the minimum payment set at 1/6th of the balance in the account. Other plans compete for customers in need of longer term financing, with minimum monthly payments ranging as low as 1/24th of the balace, and some plans have even lower minimum payments and longer terms for "big ticket" items.

Credit plans compete in other ways. Some sales promotions are coupled with special deferred payment terms. For example, sales of end-of-season merchandise in September may not be billed until the following February, with no finance charge assessed during the interim. In other special plans no finance charge is assessed at all if the customer makes the minimum monthly payment on or before its due date. These latter plans generally involve special promotions of silver, china, and/or crystal. Nonetheless, the credit terms are a competitive tool that has proven to be quite effective in retailers' struggle for a share of the credit market.

That struggle, retailers believe, is best left to the free market economy that over the years has produced a supply of goods and services that was adequate to meet consumers' demands and that did so at reasonable prices. In short, retailers exist in a competitive environment and believe firmly that the maintenance of such an environment is absolutely essential to the preservation of the high standard of living that the citizens of this Country enjoy.

The Impact on Consumers. One of the economic laws at work in a competitive marketplace is the law of supply and demand. It is a law older than our consitution and one far more impervious to change than that venerable document. One of the corollaries of the law of supply and demand is that when artificial restraints force prices down, supply is curtailed. Fewer suppliers are willing and/or able to continue offering the goods or services under the lowered price structure. Only the most efficient suppliers -- those that are able to operate at high volume on the thinnest of margins -- can remain in business. The reduction in availability on the consumer side of the equation is likewise not random across all income strata, but has its greatest impact on marginally creditworthy consumers. Those are the consumers who also typically have the lower incomes and greater need for reasonable amounts of consumer credit.

One of several ways to circumvent such a result would be for retailers to raise retail prices sufficiently to compensate for the lost finance charge revenues. Such a practice, however, is a clear form of subsidy that inhibits price competition. When credit prices are restrained artificially, retailers face several possible alternatives: (1) they could discontinue offering in-house credit altogether, thereby reducing competition among suppliers in the credit marketplace; or (2) they could raise their standards of creditworthiness and reduce the availability of credit, in which case those most in need of reasonable amounts of credit will be rejected; or (3) they could subsidize credit losses through an increase in retail prices, with the result that those customers who pay cash, whether by choice or as a result of reduced credit availability, will be paying part of the functional cost of credit that should be borne by credit customers. None of those alternatives is socially or economically desirable.

We fear that enactment of either S.1603 or S.1922 would have such a result.

The Earlier Congressional Look at Rate Ceilings. Back in 1968, Congress realized that the whole issue (actually, the whole array of issues) involved in assuring an adequate supply of consumer credit at reasonable rates was, indeed, an enigma. As a result, Congress added Title IV to the Consumer Credit Protecton Act (Pub. L. 90-321, May 29, 1968), Title I of which is the Truth in Lending Act, establishing the bipartisan National Commission on Consumer Finance and charging it with the duty to "study and appraise the functioning and structure of the consumer finance industry, as well as consumer credit transactions generally." (80 Stat. 499.)

With funding of almost $2 million, the Commission devoted more than three years to an intense study of the consumer credit marketplace and its participants. The Commission summarized its findings in a 294-page report filed with Congress in December 1972 (Consumer Credit in the United States, Report of the National Commission on Consumer Finance, Library of Congress card no. 72-600335). The findings and conclusions of the Commission were lengthy and detailed, and all pointed to regulatory restraint rather than governmental involvement as the standard to be sought for the consumer credit industry. Among its conclusions were --

- "Imposition of rate ceilings on consumer credit transactions neither assures that most consumers will pay a fair price for the use of credit nor prevents overburdening them with excessive debt." (at p. 108.)

- "The Commission recommends that policies designed to promote competition should be given the first priority, with adjustment of rate ceilings used as a complement to expand the availability of credit. As the development of workably competitive markets decreases the need for rate ceilings to combat market power in concentrated markets, such ceilings may be raised or removed." (at p. 149.)

- "Just as the level of rate ceilings may affect intra-institutional competition, so too can the structure of rate ceilings (as they apply to different credit sources) affect inter-institutional competiion. When, for example, the ceiling applicable to a given type of credit for one class of lenders is substantially below that of another class of lenders, the former class will be forced to serve mainly low risk borrowers the latter, high-ceiling class will tend to serve relativley high risk borrowers. This artifical segmentaton of the market obviously restricts inter-institutional rivalry." (at p. 137.)

This report was presented to Congress more than 13 years ago. Three members of your full Committee served as members of the 9-member Commission. The conclusions and recommendations of the Commission are as valid and efficacious today as they were 13 years ago. Thus, ARF repectfully directs the attention of this Subcommittee to the Report of the National Commission on Consumer Finance -- a study for which this Country already has paid $1.95 million -- and urges that it heed the Commission's recommendations.

The Impact on Retailers. Finally, with respect to the impact that S.1603 and S.1922 would be likely to have on the retail industry, ARF strongly recommends that the Subcommittee not adopt the rate ceiling index proposed in either measure. S.1603 would cap the rate at 5 points above the average investment yield on 26-week treasury bills, and S.1922 would limit the rate to not more than 4 points above the rate determined in accordance with section 6621 of the Internal Revenue Code. (The section 6621 rate is the six-month average of commercial bank prime rates measured on March 31 and September 30 of each year.) Neither rate is an accurate measure of the cost of funding a receivables portfolio.

With respect to the 26-week treasury bill rate, ARF respectfully points out to this Subcommittee that, although that rate is an indicator of a "market rate" of interest prevailing at the time, it is by no means indicative of the rate that retailers must pay to carry their receivables. Indeed, the market rate that must be paid by retailers varies widely with the size and credit rating of the retailer involved, the type of credit instrument used for the borrowings (e.g., short-term bank credit lines or long-term bonds), and the prevailing rate in the particular areas in which the retailers are borrowing the funds.

The bottom line is that the typical retailer does not fund its receivables with short-term borrowings at a cost measurable by the 26-week treasury bill rate; nor is the prime rate (either averaged nationwide or in the area where the retailer is located) or any other short-term credit market rate a reliable indicator of the cost of money needed to carry retail receivables. The fact is that small retailers generally fund their receivables with a mixture of proprietary capital and intermediate-term bank borrowings, and large retailers typically obtain the funds necessary to carry their receivables by using a wide array of credit instruments, ranging from long term bonds, to revolving lines of bank credit, to invested capital. Few, if any, of these sources of funding are subject to rates that bear a significant and continuing relationship to the 26-week treasury bill rate, to the prime rate, or to any short-term rate.

Moreover, the cost of funds is but one of many costs involved in operating a credit card plan. Often it is not even the major cost. Among others to be considered are postage, personnel, and office occupancy expenses (e.g., rent), to say nothing of cost of computers and the authorization system so necessary to the successful operation of any credit card plan.

As the National Commission on Consumer Finance noted, when the rate ceiling applicable to a given type of credit is substantially below that for other types of credit, the low-ceiling type will be available mainly to low risk borrowers, and the high-ceiling type will be offered to the relatively higher risk borrowers. Thus, if the Congress should decide to impose unrealistic ceilings on credit card accounts -- and we believe that the ceilings proposed in both S.1603 and S.1922 are, indeed, unrealistic -- the inevitable result will be to restrict those accounts to the most creditworthy customers and force retailers to resort to the use of closed end installment credit contracts for the less creditworthy customers, notwithstanding the fact that closed end contracts have been largely abandoned by general market retailers in recent years because they are inconvenient to use. Artifically low rate ceilings will force creditors to resort to reliance on this antiquated form of credit, one that was left in disuse with the advent of modern, electronic authorization systems that made the use of revolving credit practicable.

Consumers generally prefer revolving credit, because it is more convenient to use than is installment credit. It permits consumers to tailor purchases to available cash flow.

It must be remembered that the vast majority of consumers are not credit addicts or junkies; were that true, the credit industry could not function, for it could not survive in an environment in which large numbers of overextended consumers could not pay their debts. The vast, the overwhelming majority of consumers use credit sparingly and wisely and repay credit extensions according to schedule. Those consumers should not be forced to compete among themselves to determine the chosen few who are extremely creditworthy and who, therefore, get the right to use the form of credit that they all would prefer to use.

With respect to retailers themselves, it must be remembered that many thousands of retailers in this country today are small, locally owned operations. Some are still using mechanical billing equipment for preparing customers' monthly billing statements; others have small computers operatng with software purchased off the shelf. Still others are using service bureaus with only limited programming capabilities.

In short, many thousands of retailers in this country simply do not have the capability of using variable rates. Such an inability will force them, if either of these bills should become law, to adopt a fixed rate ceiling below the lowest foreseeable rate mandated by the variable rate formula. Given retailers' inability to adapt to variable rate ceilings, they would be forced to discontinue all finance charges when the ceiling went below their fixed rate.

Obviously, this would place the small retailer at a competitive disadvantage which might not be overcome short of discontinuing credit operations.

Summary. Over the years the retail industry has taken the position -- a position that has not changed -- that it makes no economic sense to fix the price of credit by artificial statutory restraints. The actual cost of noncredit services and the actual cost of merchandise to the retailer -- influenced, of course, by competitive market conditions -- determine the price at which the services and merchandise are offered for sale, either as a package or independently. For example, the price of a 21-inch color television set is based on the cost of that set to the retailer and the competitive market in which it is sold. It makes no economic sense, therefore, for artificial statutory restraints to fix the price that may be charged to finance the purchase of that television set, particularly in view of the fact that the cost of financing it typically is only a fraction of the cost of the set itself.

ARF urges that the cost of the credit services be subject to the same economic considerations that are involved in the pricing of the goods and other services offered for sale; the cost to the supplier and a competitive marketplace. Thus, we urge that the Subcommittee reject both S.1603 and S.1922.

ARF is grateful for the opportunity to present its views. If the Subcommittee or its staff should have any questions about the foregoing statement, ARF will be delighted to respond to your further inquiries.

1710 RHODE ISLAND AVENUE, N.W.
SUITE 500
WASHINGTON, D.C. 20036
202 296-5709

ANTHONY T. CLUFF
[illegible]

ASSOCIATION OF RESERVE CITY BANKERS

ARCB

February 24, 1986

The Honorable Jake Garn
Chairman, Committee on Banking,
Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Garn:

The Association of Reserve City Bankers (ARCB) is taking this opportunity to provide you with its views regarding the Tax Reform Act of 1985 (HR 3838). ARCB is an association of 400 banking executives representing 150 of the nation's major banking institutions.

The members of ARCB are particularly concerned over three aspects of the Tax Reform Act of 1985: (1) the treatment of loan losses; (2) the treatment of foreign-source income; and (3) the deductibility of interest costs to carry tax-exempt securities. These provisions have been justified on the basis of what has been perceived to be a low effective tax rate for commercial banks. This does not, however, take into consideration the effect which holdings of lower-yielding tax-exempt securities have on the effective tax rate of banks nor the effective tax rate which results by requiring banks to hold non-interest bearing reserves against deposits. The end result is that these provisions will have a disruptive effect on commercial banking customers and the nation's commercial banking system.

The treatment of loan loss reserves under this legislation is particularly troublesome at a time when efforts are being taken to bolster banking's capital position. Bank capital has increased significantly in recent years, and efforts are underway to enhance the capital position of banking even further. The provisions in HR 3838 which would eliminate the deduction for additions to the tax reserve for bad debts, recapture existing tax reserves in taxable income and limit banks to a deduction for charge-offs all move in the opposite direction of such efforts and fail to recognize that loan loss reserves are an important element in the capital position of banks.

The treatment of loan losses is contrary to sound economic and accounting principles. The statement of Michael P. Esposito, Jr. of the Chase Manahattan Bank, submitted to the Senate Committee on Banking, Housing and Urban Affairs, was an excellent treatment of this matter. We commend to you and your colleagues in the Senate the points raised by Mr. Esposito in that statement. In light of that testimony, we find particularly puzzling the different treatment of loan losses and loan loss reserves for institutions with $500 million or more in assets and those with less than $500 million in assets under HR 3838. If it makes good public policy to eliminate the current tax treatment of bad debt reserves, it is unclear why it does not make sense for all institutions and not just those with $500 million or more in assets. The members of ARCB do not believe, however, it makes good public policy for banking institutions of any size. The split treatment of banks in this area only compounds the ill effects of a poorly-conceived policy that is fundamentally flawed to begin with.

The proposed treatment of foreign source income under this legislation is also troublesome to the members of ARCB. The reduction in the credit for gross withholding taxes paid by banks will place U.S. banks at a competitive disadvantage relative to other banks worldwide by increasing their costs of doing business in an increasingly-competitive global banking market. Equally important is the concern that the provision will be detrimental to international lending, particularly to lesser developed countries at a time when increased lending is being officially encouraged. If this is indeed the effect of this provision, banks would be in the awkward position of being encouraged to increase their lending at the very time the U.S. tax code would be encouraging them to do the opposite.

The third major area of concern to the members of ARCB is the provision of HR 3838 which would eliminate the ability banks currently have to deduct interest costs associated with carrying tax-exempt securities. The effect of this provision will be to shift bank portfolios away from these investments, and the real loser will be the state and local governments that depend on a deep and vibrant market to finance the provision of services.

The Association of Reserve City Bankers appreciates this opportunity to share its views with you on these important matters. We would be delighted to meet with you or your staff to discuss these matters further if that would be helpful.

Sincerely,

Anthony T. Cluff

Anthony T. Cluff

The Bankers Committee
321 D STREET, NORTHEAST, WASHINGTON, D.C. 20002 • TELEPHONE: 202-544-7870

ADVOCATING TAX EQUALITY AND FAIR COMPETITION FOR THE 80's

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J. TOWNLEY CHASE
Director of Membership
Washington, D.C.

January 8, 1986

The Honorable Jake Garn
Senate Dirksen Office Building
Washington, D.C. 20510

Dear Senator Garn:

We are greatly concerned about legislation that recently passed the House of Representatives, The Tax Reform Act of 1985.

While bankers across the country generally favor tax reform designed to cut marginal tax rates, eliminate economic distortion and reduce the amount of resources devoted to tax avoidance, the Tax Reform Act of 1985 fails to meet these goals. Concerning the banking industry, the legislation simply amounts to a large tax increase which falls for the most part on smaller institutions.

This development is due to recent media reports and Joint Tax Committee studies which outline low or negative tax rates for the banking industry. It must be understood that these reports apply to money-center institutions and not banks generally. Contrary to the views of Don Regan and the tax collectors at the Treasury Department, most banks do not have negative or low average tax rates.

A survey of effective income tax rates for banks conducted by the Bank Administration Institute shows an average tax rate of about 18% for banks with $50 million in assets or less. (Our in-house survey of 300 smaller banks shows rates of 17 to 36%.) If lost earnings on Federal Reserve deposits and foregone interest earnings on tax-exempt bonds is included, implicit tax rates for banks with $100 million in assets or less equal 29%. For banks with assets of $100 million to $500 million, the implicit rate equals 36.8%. These rates compare favorably to the overall corporate average of 24%.

At a time of increased operating cost attributable to industry deregulation, and during a period of high bank failures, the last thing the Federal government should do is destabilize the system by cutting deeper into small bank income.

A SPECIAL COMMITTEE OF THE NATIONAL TAX EQUALITY ASSOCIATION

These issues are vital to a strong community banking system which provides needed credit opportunity to small business and rural communities. While a few money-center institutions may have exceedingly low tax rates, Congress should not heap big tax increases on the entire banking industry.

We look forward to discussing these issues with you and your tax staff in the next few months as the Senate Finance Committee reviews tax reform legislation.

Sincerely,

Edward N Delaney

Edward N. Delaney
President

STATEMENT OF EDWARD N. DELANEY
ON BEHALF OF THE BANKERS COMMITTEE

STATEMENT SUMMARY

The Bankers Committee, a membership organization of more than 1000 banks from across the country is concerned about the impact of House-passed tax reform legislation (H.R. 3838) on the financial industry. The committee's chief concern is that smaller banks are not burdened with large tax increases at a time when deregulation and increasing bad debts are straining bank earnings.

Our testimony outlines the importance of maintaining a bad debt reserve as an accurate measurement of taxable income. H.R. 3838's elimination of the reserve method of accounting will cause overstatement of banks' income and earlier write-off of non-performing loans. This will hurt small businesses and farm borrowers. Actually, because of increasing bad debts and bank regulators' desire to increase bank capital ratios, a reserve method that conforms to reserves reported for financial statements would be more appropriate. We endorse legislation to implement this method which has been introduced by Senator Roth (R-Delaware).

Concerning restrictions on deductions for banks' investment in state and local tax-exempt bonds, our testimony outlines the problems the proposed modifications will create for local governments attempting to finance projects at reasonable cost. Basically, the restrictions will greatly limit the amount of bank investment in bonds and state and local governments would have to find new markets at greater expense.

Finally, our testimony questions why the fastest growing segment of the financial industry is not required to contribute to the U.S. Treasury. Credit Unions now offer products similar to banks and thrifts, and serve mostly middle income Americans. There is no tax policy justification for retaining tax exemption for credit unions. Growth rates and aggressive marketing tactics are outlined in the testimony and we recommend that credit unions be taxed in the same manner that other cooperative organizations are now taxed.

The Tax Reform Act of 1985 - Economic Impact and Effect on Financial Institutions

INTRODUCTION

Many months of intense negotiation between House tax Members, the Administration and numerous interested groups culminated in the legislation sent to the Senate. The Tax Reform Act of 1985 (H.R. 3838). Mr. Chairman you have wisely requested that financial institutions and others concerned over the impact of the bill outline their support of or problems with the bill.

Tremendous changes are taking place in the financial industry due to technological changes and deregulation. These as well as other factors influencing competition, operating expense, and macroeconomic considerations are of great interest to all involved. Fiscal policy and Federal income taxes play significant roles in commercial banks' ability to compete and operate profitably.

The Bankers Committee, a membership organization of approximately 1000 banks appreciates this opportunity to present our views on certain aspects of the Tax Reform Act. Even though the Senate Finance Committee may not work from the House passed bill, the issues we discuss will undoubtably find their way into the Committee's deliberations. We hope our comments are helpful to the Committee Members and other Members of the Senate.

The early attention given the tax overhaul measure indicates that the bill does indeed comprise major tax revision, although some would hesitate to call it "tax reform". To some, a reduction in individual tax rates of 9 percent financed by $140 billion in corporate and business tax increase represents reversal of the President's 1981 tax act designed to stimulate investment and economic growth. Others view the measure as a positive development in a series of tax reform efforts with the Tax Equity and Fiscal Responsibility Act and the Tax Reform Act of 1984 as building blocks.

What must be remembered are the goals of tax reform, a more nuetral sytem, low marginal rates to encourage work and thrift, and a halt to tax avoidance. This would promote a sound, growing economy.

At this time, we are not prepared to endorse this legislation as a means to achieve these goals. in fact, in a statement to House Ways and Means Chairman Dan Rostenkowski earlier this year, we urged consideration of a plan much different than what we are discussing today.

The Bankers Committee urged the Committee to examine a sweeping proposal that would go a long way to simplify the tax code, eliminate high marginal rates and the resulting loss of economic resources devoted to tax avoidance and shrink substantially the underground economy which cost the Treasury billions.

The plan for business is a flat tax of 19% with deductions only for usual business expense. According to authors of the plan Stanford economist Dr. Robert Hall and his collegue Alvin

Rabushka, the plan would have brought into the tax base economic income sufficient to raise corporate Federal income tax revenues by 20 percent in 1980. Considering that the effective tax rate of corporations in 1981 was about 23%, the simple flat tax presents an interesting alternative.

Right now, I would like to respond to your questions Mr. Chairman about the impact of H.R. 3833 on our predominately small bank members.

Even with the corporate rate reduction from 46% to 36%, most of our members would experience tax increases. More importantly, the bill fails to address an issue of tax policy that has been a chief concern to this group for many years. That issue being equal treatment of similar income. This concern is dealt with in detail in Section I of our statement on bad debt reserves and Section III on credit union tax treatment. Before we address those issues, let me briefly discuss the environment surrounding bank tax treatment and policymakers who formulated the financial institutions section of H.R. 3838.

For many years, Congress has heard much about the effective tax rates for commercial banks. Both the Joint Tax Committee and the U.S. Treasury have stated or published information that details low or negative tax rates for the twenty largest banks in the country. As most of the Members of this committee are aware, these tax rates do not reflect the total contribution banks make to Federal Revenue. Last year alone, the Treasury Department raised $ 2 billion from banks through interest income from Federal Reserve mandated deposit reserve accounts. This significantly raises the effective tax contribution of banking to Federal government finances and we appreciate your consideration of this issue.

Now I will discuss provisions of specific interest to the members of the Bankers Committee.

Section I BAD DEBT RESERVES

Since 1921, banks have been permitted to use a reserve method in calculating the federal income tax deduction for bad debts. The reserve account is, in effect, an offset to a bank's outstanding loan assets, reflecting the fact that a portion of outstanding loans will prove to be uncollectible. Under the reserve method, the bad debt deduction for a taxable year is equal to the amount required at year-end to restore the reserve to an appropriate level computed under certain approved methods.

The House tax bill (H.R. 3838) would reverse this 65-year history and experience in the case of "large banks" (i.e. generally, banks having assets with tax bases exceeding $500 million) requiring use of a specific charge-off method. A deduction is allowed for bad debts only when a particular debt owed the bank becomes either wholly or partially worthless. Moreover "large banks" would generally be subject to recapture of the existing bad debt reserve under a provision that requires the entire reserve amount to be added back to a bank's taxable income over a 5-year period.

The specific charge-off method in H.R. 3838 represents bad tax policy, and it should be rejected by the Senate. Instead the Senate should adopt the Roth-Flippo proposal that retains the reserve method of accounting for bad debts and requires generally that the bad debt reserve for tax purposes be conformed to the bad debt reserve maintained for financial statement purposes.

Problems With Specific Charge-Off Method Required Under H.R. 3838

A mismatching of income and expense is inherent in the specific charge-off method. The proper measurement of a bank's net income must take into account the fact that interest received on outstanding loans is partially offset by the subsequent failure to collect interest and principal on loans in the portfolio that ultimately prove to be bad. If a loan loss is not deducted until a specific loan becomes completely worthless or partially worthless, a bank is required to report interest income on good loans (and perhaps on bad loans) prior to the time it reports the related loan portfolio loss. The result is an overstatement of a bank's current taxable income.

This mismatching of income and expense under the charge-off method has resulted in its rejection by accountants and financial regulators as a proper means of financial reporting for banks. Banks are required for financial reporting purposes to maintain a reserve for bad debts to reflect accurately the value of the loan portfolio and the amount of net income for any accounting period. In the absence of a reserve account a bank's soundness may be imperiled by an artificial inflation of assets and income.

The proponents of the specific charge-off method concede that the method results in a current mismatching of income and expense, but they argue that the mismatching is subsequently corrected. They argue that a "risk premium" increment is collected on good loans to compensate for losses on bad loans and that the present value of the incremental income is equal to the present value of the loss. Under this theory, the present value of the current additional tax liability on the incremental income is said to be equal to the present value of the tax savings that will result later from a claiming of the loss. The theory flies in the face of principles that have long been required for bad debt reporting by the accounting profession, the SEC, and bank regulators. But, even if the theory was correct in an academic sense, it does not reflect real world situations. The inherent mismatching under the specific charge-off method is increased considerably when it is applied in practice.

The theoretical argument for the specific charge-off method is apparently based on the assumption that a charge-off is made, and a loan loss deduction is therefore available, at the precise moment a loan becomes non-performing (i.e., at the moment there is any default on payments of interest or principal). In fact, charge-offs typically occur after a protracted period of non-performance and may be delayed until all efforts to structure a work-out arrangement with the debtor completely fail. The result is a deferral of a loan loss deduction under the specific charge-off method substantially beyond the time assumed by the theoretical proponents.

There can be little doubt that the specific charge-off in actual operation would overstate current income and would fail to provide adequate understatement of income in later years to compensate.

In addition to the fundamental flaw of income overstatement, other problems would be created by the bad debt provisions of H.R. 3838. For instance, the specific charge-off method is especially difficult to administer.

In practice, the charge-off of specific loans is not a process conducted with mathematical precision. It calls for an exercise in judgment by bank officials and can provide considerable latitude for determining the particular moment when a loan is completely or partially "worthless." This inherent uncertainty, and resulting abuse potential in the specific charge-off method led to the Congressional decision 65 years ago to provide for the use of reserves to account properly for loan losses.

Moreover, the required use of the specific charge-off method may have an adverse impact on bank lending practices. Since the charge-off method necessarily links the loan loss tax deduction with the timing of the bank's write-off determination banks will have a tax incentive to write off loans earlier than general bank procedures might otherwise dictate.

This incentive for earlier write-offs can be expected to work to the disadvantage of debtors experiencing temporary financial difficulties. The impact of this development could be especially harmful to certain small business sectors and of course, the agricultural sector of the economy.

During Congressional discussions of the minimum tax on preferences in 1983 and 1984, the Bankers Committee recommended removing bad debt reserves from the list of preferences subject to the minimum tax and an increase in the bad debt reserves rate for banks with large agricultural portfolios in order to avoid this very problem.

In 1986, these problems are even more pressing. Eliminating reserve accounting in this environment would be especially short-sighted. The problems that would arise for banks and their customers would far outweigh any conceivable benefit to the Treasury from the specific charge-off proposal. Relatively little revenue is gained from the reduced bad debt deduction under the proposal.

Most of the gain would be realized from the provision for a recapture of existing reserves. The bill would force banks to include in their income all exsisting reserves over a five year period or alternatively through a so-called cut-off method having about the same effect.

Regardless of what decisions are made with respect to the basic bad debt issue, the recapture provision seems especially onerous. On many other occasions when Congress has required accounting changes, there has been no recapture from the taxpayer. For example, there was generally no recapture with respect to accounting changes required by enactment of the 1954

Internal Revenue Code, nor was recapture required with respect to the substitution of the FSC provisions for the DISC provisions in the Tax Reform Act of 1984. The Congress should be suspicious of a proposal whose chief virtue appears to be its ability to extract revenue through an onerous transition rule.

Finally, we would like to dispel any notion that the bad debt changes would affect only large banks. The authors of H.R. 3838 believe that they have arrived at a formula which would increase effective-taxes on "large banks" by subjecting banks and banks that are members of holding company groups with total assets of $500 million or more to bad debt resrictions and the recapture tax. Unfortunately for many smaller banks, especially those in economic sectors experiencing increasing rates of non-performing assets, this arbritary cut-off incorporates their institutions. Under H.R. 3838 groups of smaller banks that have formed a holding company are subject to the change. The following examples of instititions that fall into this category illustrate the problem.

A SAMPLE OF BANK HOLDING COMPANYS SUBJECT TO RESERVE ACCOUNTING METHOD CHANGE

Remember, these institutions will also be subject to the recaputure provisions which require the banks to add back to income the current amount of bad debt reserves or account for loans outstanding on the cutoff method.

BANK NAME	CITY	ST	ASSETS
MAGNA GROUP INC.	BELLEVILLE	IL	
First N.B. of Belleville	Belleville	IL	$348,832
Bank of Belleville	Belleville	IL	180 290
First N.B. in Columbia	Columbia	IL	52,232
Fairview Heights Cmnty Bank	Fairview Hgts	IL	31 016
First N.B. of Marissa	Marissa	IL	30,720
Dupo State Savings Bank	Dupo	IL	25,787
First N.B. of Smithton	Smithton	IL	11,595
Illinois State Trust Company	Belleville	IL	0
First N.B. of Freeburg	Freeburg	IL	27,012
MAGNA GROUP TOTALS		$707,484 ASSETS	
BRENTON BANKS, INC.	DES MOINES	IA	
Brenton N.B. of Des Moines	Des Moines	IA	203,802
Fidelity Brenton Bank & Trust	Marshalltown	IA	92,440
Brenton First National Bank	Davenport	IA	82,729
Poweshiek County N.B.	Grinnell	IA	77 819
Brenton Bank & Trust Company	Adel	IA	64,275
Brenton National Bank of Perry	Perry	IA	63,888
Community N.B. & T.C. of Knxvlle	Knoxville	IA	58,824

Brenton State Bank of Jefferson	Jefferson	IA	55.982
Brenton State Bank	Dallas Ctr.	IA	51,020
Palo Alto County State Bank	Emmetsburg	IA	50 759
Brenton Bank & Trust Co.	Urbandale	IA	39,462
Brenton Bank & T.C. of Vinton	Vinton	IA	34,014
Warren City Brenton B & TC	Indianola	IA	33.188
Brenton Bank & Trust Co.	Clarion	IA	32 258
Brenton B & T.C. of Cedar Rapds	Cedar Rapids	IA	30.847
Brenton State Bank	Eagle Grove	IA	21 850
BRENTON GROUP TOTALS			$993 157 ASSETS

HAWKEYE BANCORPORATION	DES MOINES	IA	
Jasper County Savings Bank	Newton	IA	109.801
Hawkeye-Capital B & T.C.	Des Moines	IA	105,824
Hawkeye Bank & Trust Company	Burlington	IA	102,170
First National Bank	Clinton	IA	78,855
Citizens N.B Boone	Boone	IA	78.172
Hawkeye Bank & Trust Co.	Humboldt	IA	76.155
Pella National Bank	Pella	IA	74 338
Hawkeye Bank & Trust Co.	Maquoketa	IA	74.083
Houghton State Bank	Red Oak	IA	69 255
Hawkeye Bank & Trust Co. N.A.	Centerville	IA	65,980
Hawkeye B & T.C. of Des Moines	Des Moines	IA	63.983
Commercial State Bank	Marshalltown	IA	61.410

Hawkeye Bank & Trust Co.	Mt Ayr	IA	51.234
State Bank of Vinton	Vinton	IA	47,138
United State Bank	Cedar Rapids	IA	46 963
Tipton State Bank	Tipton	IA	44,643
Onawa State Bank	Onawa	IA	44.004
Waukon State Bank	Waukon	IA	42,581
Hawkeye Bank & Trust Co.	Spencer	IA	41,101
National Bank of Washington	Washington	IA	40,800
Lyon County State Bank	Rock Rapids	IA	37.915
Hawkeye Bank & Trust Co.	Chariton	IA	37,675
First National Bank in Lenox	Lenox	IA	33.813
Hawkeye Bank & Trust Co.	Grundy Center	IA	31,485
Hawkeye Bank & Trust Co.	Mt. Pleasant	IA	28.415
Hawkeye State Bank	Iowa City	IA	26,099
Hawkeye B & T.C. Mason City	Mason City	IA	25 758
Hawkeye-Ankeny Bank & Trust	Ankeny	IA	25,436
Lake City State Bank	Lake City	IA	25.178
Hawkeye Bank & Trust	Lake Mills	IA	24.789
State Bank of Allison	Allison	IA	22.489
First National Bank of Sibley	Sibley	IA	20,820
Hawkeye Bank & Trust Co.	Eldora	IA	20.501
Hawkeye Bank & Trust Co.	Camanche	IA	15,283
HAWKEYE GROUP TOTALS			$1,807,425 ASSETS

This is just a limited sample of the small banks that are caught up in the definition when holding company members are included for purposes of the $500 million cut-off. The provisions would have significant impact on many community banks across the county.

The Reserve Method of Accounting Should Be Retained for Banks and Improved by Adoption of the Roth-Flippo Proposal.

The Roth-Flippo proposal would retain a reserve system for deducting bad debts as long as the amount of the reserve generally conformed to the bad debt reserve maintained for financial statement purposes. However, the maximum bad debt reserve could not exceed 1.5% of the total loans, and the maximum bad debt deduction in any taxable year could not exceed 0.5% of total loans outstanding at the end of that year.

This approach reflects the fact that a bad debt reserve is needed to match properly the income of the loan portfolio with related expenses resulting from bad debt losses. It also reflects the fact that the most reliable indicator of the proper amount of reserve is the amount that is reported as a reserve for financial purposes.

There is a natural tension between financial reporting and tax reporting that should act to keep bad debt reserves within reasonable bounds. Any determination of bad debt losses, whether through a reserve method or a specific charge-off method will be imprecise and will present some abuse potential. However, any tax benefit associated with overestimation of reserves will generally be more than offset by the disadvantage of underreporting financial income.

Therefore, the Roth-Flippo conformity approach provides a self-regulating mechanism for accurate matching of income and expense.

Thrift Institutions' Percentage of Taxable Income Method

The treatment of thrift institutions in H.R. 3838 as regards provisions on bad debt reserves brings into question the entire basis for the treatment of commercial bank's bad debt reserves. Somehow, the committee devised justification for continuing very favorable treatment for savings and loans as compared to commercial banks and taxpayers generally.

The bill provides that thrifts will be allowed both the experience method and percentage of income method for bad debt reserve deductions. Any institution meeting a "thriftness test" will be allowed a deduction up to 5 percent of income. Additionally, institutions which claim the 5 percent of taxable income method will not be considered as having obtained a tax preference for purposes of the 20-percent reduction.

This preferential treatment bestows a competitive advantage over commercial banks and should be eliminated.

Section II TAX-EXEMPT CARRYING CHARGES DISALLOWANCE

H.R. 3838 disallows 100 percent (as opposed to 20 percent under current law) of the deductions for interest expense attributable to exempt obligations obtained after December 31, 1985.

Commercial banks purchase tax-exempts for a number of reasons including asset diversification and the opportunity to fulfill obligations to their local community.

Across the country, there are a number of communities that have no bond rating or an inferior rating. Local banks provide the only markets for such offerings. Due to recent legislation, this market is declining. Tax law modification in the 1982 Tax Equity and Fiscal Responsibility Act and the 1984 Tax Reform Act which reduces the carrying charge deduction by 20%, has had substantial impact on the willingness and ability of banks to invest in such bonds. According to Federal Reserve System 1984 flow of funds reports, $547 billion in tax-exempts bonds were distributed in the following ratios among different investors: Households were the largest investors with 38.8%, commercial banks were second with 32%, property and casualty insurance firms held 15.5%, mutual funds held 8.2% and life insurance firms possessed 1.8%. Other investors account for the remaining 4%.

The relevance of these figures does not become apparent without a comparison to years prior to 1983 when banks traditionally had been the largest holder of tax-exempt bonds with 50 to 60% of the total market.

In discussions with numerous bank Presidents about the impact of the 1982 and 1984 tax law changes and the prospect for a 100% disallowance, many stated that they could no longer invest in the state and local bonds because of the inherently higher risk, lack of liquidity and low return.

To maintain a bank market, state governments would have to at least match the interest rate of U.S. Treasury instruments, and local communities would have to surpass that rate by 50 to 75 basis points or more. Otherwise bank management would violate its fiduciary duty to stockholders if it acquired such bonds. A study conducted on the impact of an Internal Revenue Service ruling designed to terminate deductions for certain public deposits secured by tax-exempt securities concluded the ruling would have increased cost to local governments by up to $2.15 billion.

Importantly, it should be noted that strong opposition was voiced at Senate Finance Committee hearings on Tax Reform and Tax-Exempt Bonds hearings September 24, 1985. John T. Walsh, Finance Director of the Government Finance Officers Association stated:

> "The Government Finance Officers Association opposes the Administration's proposal on tax-exempt bonds because it affects general obligation bonds and revenue bonds issued for governmental purposes. The elimination of the deduction taken by banks and other financial institutions for the cost of buying and carrying bonds will hurt many small jurisdictions that rely on local institutions for their capital financing."

The State Treasurer of South Carolina, Grady Patterson, Jr., said this about the proposed change,

> "Prior to 1982, a 100% deduction was allowed for such cost incurred to buy or carry tax-exempts, and the elimination of such deduction will drive away and eliminate a large segment of our market for municipal bonds. I urge the removal of the proposal to deny deduction for cost incurred in buying and carrying tax-exempt obligations."

These are just a couple of the comments at the Finance Committee hearing that demonstrate the adverse affect on local communities of H.R. 3838's provision on bank interest costs.

Banks often purchase tax-exempt bonds to meet required pledging obligations for public deposits in excess of deposit insurance limits. Approximately 35 states and numerous local governments require banks to secure public deposits with bonds issued by the state or local government. These relationships will be disrupted by H.R. 3838 to the disadvantage of the states and local communities.

It must be clearly understood that the tax advantage derived from bank investment in municipal bonds is passed through to the communities. This role of financial intermediary was devised by the Congress to reduce the local economic burden when educational, infrastructure and other projects require financing. A change in the tax code which eliminates the ability of banks to participate in such bonds, unless rates are increased systematically, will not alter bank's profits, but will affect total investment in such instruments unless new markets can be found.

The deduction for state and local bonds does not constitute a "tax loophole or preference" but instead comprises a long accepted Federal policy of encouraging local communities to institute self-development measures. The practical effect of the present carrying cost deduction is to reduce the overall cost of financing for worthwhile projects. Not only do the proposed changes in current law treatment of tax-exempts impact the issuance of such bonds, but also the market for bonds now held by banks.

Troubled banks may need to sell municipal obligations they now hold in order to replace them with higher earning assets. This liquidity will be severely restricted by tax changes under H.R. 3838. In order to maintain a market for obligations previously purchased and maintain a reasonable incentive for bank investment in State and local bonds by banks, Bankers Committee recommends the following modifcations of the prosposed act:

1) An exemption from the 100 percent disallowance for any bonds acquired from a bank that were held by that bank since enactment of the tax bill.

2) Elimination of the requirement in the transitional rule that limits the continued 100% deduction to bonds issued in the same state as where the bank is located. Many communities are located in more than one state and their natural market is multi-state. Also, some states have virtually no local bond market.

3) Raising the $10 million annual aggregate limitation to at least $25 million. The arbitrary $10 million is far too low considering the infrastructure and and the need of states and communities.

4) Change of the transitional rule to a permanent exemption.

Clearly, any geographical or excessively low dollar amount limitation constitute legislative "overkill" and an undue burden on state and local communities.

Section III CREDIT UNION COMPETITION AND TAXATION

For a number of years, the Bankers Committee has advocated the taxation of credit unions. Although the credit union industry has experienced extensive growth in the past few years, head-to-head competition with tax exempt credit unions has concerned community bankers since the early sixties.

More recently, independent bankers that are attempting to deal with increased operating expense brought about by financial deregulation, find their credit union competition more sophisticated and quite effective at luring away customers.

Consider the following statistics outlining growth of the CU industry.

Credit union representatives assert that their growth is not disproportionate from other classes of financial institutions, exclaiming that 98 percent of Federal credit unions had assets of less than $100 million. How can these small financial institutions compete with commercial banks like Citibank and Bank of America? Well, that question has never been the issue. The issue of competitive equity centers on a $25 or $50 million credit union competing with a $25 or $50 million commercial bank. Two small financial businesses, competing for the same group of customers in the same geographical area. Only one has considerably less regulatory burden and tax obligation.

This is where the figures on credit union growth shed some light on competitive equity.

Today, credit unions are the fastest growing financial institutions in the nation. There are almost 20,000 credit unions compared to 14,000 banks. Membership growth has been vigorous since the 1960s, more than doubling from about 21 million to 49 million by the end of 1983. Credit unions surpassed the 50 million member mark in 1984 and by mid-1985 reached an all time high of 51.6 million members. That equals almost one-fifth of the U.S. population.

Savings at federal credit unions surpassed $54 billion in 1983. A growth rate of 20.7 percent for the year which was more than twice the deposit growth rate for commercial banks. For a twelve month period ending in August 1985, savings continued to grow at an annual rate of 20.8 percent for all credit unions. For Federal credit unions, savings surged by $8.3 billion to $66.2 billion, which compares very favorably to $3 billion of growth for the same period a year earlier.

Figures for loan growth are equally impressive. During 1983, loans at Federal credit unions grew 18 percent. For all credit unions, total loans outstanding soared 28 percent. For a twelve month period ending in mid-1985, loans outstanding increased by 15.1 percent. A period of low loan demand for most financial institutions.

Finally, some brief figures on overall growth of the credit union industry. Total assets demonstrate year in and year out growth experienced by the credit union industry. In 1975, total assets equaled $37.9 billion, by 1980 the industry expanded to

$72.4 billion. The magical $100 billion mark (the point at which savings and loans where subject to Federal taxation) was achieved in 1983. Total asset growth for twelve months ending in August hit a rate of 20.8 percent, pushing the industry to $133 billion in assets.

Historically, infant industries have been granted tax subsidies to promote provision of the anticipated benefits to the American public. Just as judiciously, Congress has been called upon to remove tax favoritism when self-sufficiency is achieved. When one examines the viability and robust condition of the credit union industry, it is obvious that complete tax exemption is no longer necessary.

. Importantly, when one looks beyond the growth figures to determine who the patrons of credit unions are, a different profile emerges than what one would expect from a "self-help" oranization providing financial opportunities for low-income Americans.

This examination brings our analysis to the heart of the argument for or against continued tax exemption. Have credit unions drifted away from their non-profit and/or mutual orientation?

The Credit Union National Association has from time to time published a national member survey. This extensive report contains nearly 100 tables and provides considerable information on typical credit union members and their use of financial services. It covers members and, for comparative purposes, nonmembers as well. While the study is slightly slanted toward members of smaller credit unions, it is the best information available. To get an idea of the membership of large credit unions, simply consider some of the top few credit unions by name. The characteristics of their membership are obvious. Credit unions, such as the Navy Federal Credit Union with 700,000 members and over $1.6 billion in assets, the Pentagon Federal Credit Union and the United Air Lines Credit Union do not have a majority or even a large percentage of low-income members.

Overall, the study found that CU members are somewhat younger, more affluent and more concentrated in professional and managerial occupations than non-members. They are more likely to own their own homes, and a far greater portion have income above $25,000.

It is interesting that credit unions were viewed most favorably on price comparisons rather than services. Best loan rates and best interest on savings were primary motivating factors for membership while many respondents stated that commercial banks remained their primary financial institutions. Contrary to the views expressed by representatives of the credit union industry, the report demonstrates that most members have accounts at various financial institutions and do not rely only on the credit union for services. Only about one-third stated that they had their main account with the credit union.

The customer profiles raise the spector that credit unions are simply transferring federal benefits to individuals with the good fortune to work at a company that sponsors a credit union or with the equally good luck to live in a community that has somehow acquired a credit union. We doubt that Congress originally intended to provide tax exemption to these types of institutions.

While growth and expansion is the goal of any business organization the desire to aggressively compete with other sectors of the financial industry has moved credit unions away from their original purpose. The more affluent and better educated customer base of credit unions outlined by Credit Union National Association's survey is due not only to pricing advantages bestowed by Federal and State tax benefits but also by an array of new products and marketing techniques.

Consider the following examples of products, who might use the products and whether the Federal government should subsidize the activities.

*Litton Employees Federal Credit Union offers members a discount brokerage product with margin accounts capacity to trade options, securities, etc. A similar product is offered by IBM's credit union service corporation, American Brokerage.

*A policy adopted by the National Credit Union Administration in November of 1984 encourages credit unions to form "senior clubs" and enroll senior members without regard to common-bond or income.

*A credit union owned service corporation was recently initiated to process VISA and Mastercard payments and otherwise manage credit card services for members.

Of course federal legislation has made various financial products available to CUs including second mortage loans, share draft accounts (which function like checking accounts) and $100,000 share insurance on individual accounts, just to name a few.

Again, while growth is the goal of all business organizations, growth also leads inevitably to changes in businesses. It is evident that this has occurred in the credit union industry. The array of products similar to other financial institutions and the deterioration of common-bond have vastly changed the characteristics of credit union membership.

Apply Cooperative Tax Law to Credit Unions

While many members of the Bankers Committee would prefer to see complete taxation of income without regard to the concept of mutual ownership and the corresponding limitations on economic income, we are today endorsing the tax reform proposal outlined by the Administration in the "The President's Proposals to the Congress for Fairness, Growth and Simplicity" presented to the Congress in May of 1985.

Essentially, the proposal is an attempt to conform credit union taxation to current law regarding mutual type organizations. Surprisingly, few have noted that credit union tax exemption is highly unusual treatment for a service, membership organization. While cooperative organizations are generally considered by the Treasury Department to merit "pass-through" treatment, much like a partnership, they are not accorded complete tax exemption.

The adminstration's proposal is not simply a measure to advance competitive equity, but indeed is an attempt to correct an abuse of a basic tax policy tenant of taxing similar income in a similar manner.

. Credit unions, if they are true cooperative business organizations should be taxed under Subchapter T of the IRC, which applies generally to all types of co-ops. Importantly, Subchapter T provides special treatment with a deduction for earnings distributed to members not allowed other taxpayers.

This special treatment provides for taxation of distributed earnings only once, allowing the business entity tax exemption on distributed earnings. In the case of credit unions, income tax paid at the Federal level would be reduced by distributing dividends to members.

As with other cooperative businesses, fair tax treatment would dictate that provisions of Subchapter T apply to all credit unions regardless of size to ensure that the benefits of single taxation are available to all consumers.

Mr. Chairman, we appreciate this opportunity to present our views to this important Senate Committee and our staff will be happy to provide any assistance necessary as legislation is developed to enact tax reform.

Cain Brothers, Shattuck & Company
101 Park Avenue
New York, New York 10178
212-692-9393

February 14, 1986

Senator Alfonse M. D'Amato
United States Senate
Washington, D.C. 20510

Dear Senator:

The work which the Senate Finance Committee is now undertaking in drafting fair and equitable tax reform legislation will have far reaching impacts on Federal budget deficits and on the Nation's economy as a whole. While you are giving consideration to these "global" issues, it is also important to bear in mind the impact any such legislation will have on the provision of services vital to the Nation's well-being.

Of particular concern to me is the impact the proposed limits on tax-exempt financing will have on the availability and delivery of health care services to our fellow citizens. Having worked first hand with many not-for-profit hospitals, I would like to share several thoughts relating to the importance of tax-exempt financing to the Nation's health care network:

- Making sure that the healthcare services are available for all our people is a National priority.

- Healthcare services are provided by (a) taxable for-profit companies; (b) not-for-profit community, charitable or religious organizations; and, (c) State and Federal Governments.

- Not-for-profit providers fill an important need within the Nation's healthcare network. For-profit companies seek profit maximization. These companies face financial disincentives in providing healthcare to the lower income Medicare, Medicaid or totally indigent segment of the healthcare population. As a result, not-for-profit providers have increasingly had to assume the "burden" of providing services to those patients who cannot pay the full cost of their care.

- Healthcare Reimbursement Policies are in flux, putting hospital revenues under great pressure (DRG system). Also, uncertainty continues to reign relating to capital cost reimbursement by Medicare for healthcare providers.

- Healthcare is very capital intensive: Replacing facilities built in the 1950's and 1960's (financed by Hill-Burton, et al at low interest rates) and building new facilities in growth markets is expensive ($175,000-$225,000 per fully equipped bed). New technology required for advanced treatments adds to the high capital requirements of healthcare providers.

- Tax-exempt financing is essential to not-for-profit providers in maintaining their competitive viability versus for-profit providers in terms of cost of capital.

  Example: The after-tax cost of debt to a for-profit provider (tax rate of 46%) borrowing at 11% taxable is 5.94%. A not-for-profit provider even assuming the availability of tax-exempt financing, would today pay 8-9%. Without tax-exempt financing, this 2-3% cost of capital disadvantage grows to 5% -- a significant differential in this low margin business. Tax-exempt financing provides a more level playing field for not-for-profit and for-profit competitors.

- The healthcare industry is undergoing rapid change and consolidation, with the number of hospitals closing forecasted to increase significantly over the next five years. Additional jolts to the system, such as eliminating access to tax-exempt financing for not-for-profit providers, can only exacerbate the failure rate -- possibly to the point of weakening the nation's network of healthcare facilities for meeting our citizens' healthcare needs.

One additional point. The uncertainty as to what the new tax-exempt provisions may be and whether the January 1, 1986 effective date will be applicable is causing great disruptions in financial planning among not-for-profit healthcare providers. Rather than taking actions to finance in today's more attractive interest rate environment, these hospitals are frozen in limbo awaiting some definitive word or legislation out of Washington regarding the future availability of tax-exempt financing. This uncertainty is not good for the financial markets, the individual hospitals, nor for the nation's healthcare network. I would urge members of the Senate Finance Committee and other Congressional leaders to give prompt consideration to relieving this uncertainty prior to the ultimate passage of any tax reform bill.

Thank you for the opportunity of presenting these thoughts for your consideration.

Sincerely,

Vinton L. Rollins

Vinton L. Rollins

H.R. 3838 DEFICIENCIES IN THE CONTEXT OF BANKING PUBLIC POLICY NEEDS

Statement of Michael P. Esposito, Jr.
Executive Vice President
The Chase Manhattan Bank, N.A.
Submitted to the
Committee on Banking, Housing and Urban Affairs
United States Senate
5 February 1986

My name is Michael P. Esposito, Jr. I am an Executive Vice President and Controller of The Chase Manhattan Bank, N.A. I am pleased to have the opportunity to submit to the Committee the views of The Chase Manhattan Bank on tax reform and H.R. 3838, the "Tax Reform Act of 1985." Chase is the country's third largest bank, with worldwide deposits of approximately $59 billion and assets of approximately $78 billion. We employ approximately 47,000 people, of whom some 27,000 work in the United States.

Throughout the debate on tax reform that has occupied us for some fourteen months now, we (along with many others) have expressed strong conceptual support for tax reform. And, like many others, we have had a very specific idea of what such reform entails -- and what it doesn't. Chief among its objectives, we believe, are the goals of fairness, simplicity and growth enunciated early on by President Reagan.

On these three grounds, H.R. 3838 is seriously deficient insofar as the banking industry is concerned. It can hardly be described as "fair" to chop the industry into two pieces for tax purposes by arbitrarily retaining tax bad debt reserve accounting for some banks while eliminating it for others. It is hardly "simplification" to confuse the issue of bank bad debt reserves so totally as to obscure the relationship between tax policy and broader public policy needs. It is not "growth"-oriented to adopt rules that are highly likely to discourage individual savings in IRAs. Nor is it in the interest of American industry to adopt changes in the foreign tax credit that reduce U.S. banks' international competitiveness.

Taking these last points first, we believe that H.R. 3838's IRA provisions are highly unsatisfactory. With the U.S. now a debtor nation, and with a savings rate of 6.25% (as opposed to Japan's 18.25% or Germany's 11.5%), we believe it is important further to encourage IRAs, which now account for $172 billion in personal savings. The United States may be tapping global capital sources very effectively now, but we cannot assume that such resources will be indefinitely abundant. Nor does it appear to be in the long-term national interest to be a debtor nation, financing productive capacity but unable to create real wealth.

Right now, our econometric projections show capital needs in this country of over $8 trillion by 1990 (vs. $3.8 trillion in 1980). By 1990, the needs of households will exceed $2.5 trillion; those of business another $2.5 trillion; and the federal government over $2.6 trillion. By the year 2000, households will seek over $5 trillion, business $5.5 trillion, and the federal government $4.8 trillion. Where will this capital come from, if our savings rate remains so low?

It is therefore highly worthwhile to ask some simple questions regarding the impact of our tax code -- and proposed changes to it -- on personal savings.

As you will recall, the first Treasury proposal went a long way towards strengthening savings by providing a strong -- and badly needed -- stimulus to IRAs. Treasury I increased the IRA deduction to $2,500 and allowed a nonworking spouse to deduct to the same maximum, for family savings of up to $5,000 a year. However, the next version (the President's proposal), while including a new spousal deduction, reduced the ceiling back to the current $2,000 level, for a family total of $4,000 per year. This benefited only families with a nonworking spouse, and eliminated any increased IRA incentive for single people or married couples where both spouses work. In addition, the proposal reinstated 401(k) plans and set them up as an alternative to IRAs, a move which we criticized at the time as likely to discourage IRA savings.

But H.R. 3838 has gone even further, and it represents a real retrogression from current law.

H.R. 3838 fails to provide any expansion in IRA contributions for anyone, including nonworking spouses; thus, the overall ceiling for such families remains $2,250 and for two-worker families $4,000. In addition, like the President's proposal, H.R. 3838 provides for a dollar-for-dollar reduction in permissible total IRA contributions for any funds contributed to a 401(k) plan. Obviously, this is a strong disincentive to IRA savings for anyone with access to a 401(k) plan. Just as important, the $7,000 per person annual cap on 401(k)s provides an interesting contrast to the $2,250-to-$4,000 per family annual cap on IRAs. After all, IRAs are universally available, while 401(k) plans are restricted. If the intent is to provide a savings incentive to the widest possible segment of the American population, it is difficult to understand the disparity of treatment between IRA and 401(k) ceilings, and the deliberate disincentive to IRA savings.

Turning to H.R. 3838's foreign tax provisions, we believe that the drastic reduction in credit for gross withholding taxes paid by banks would have a number of severely negative impacts.

First, in increasing U.S. banks' costs in international markets -- where margins are sometimes as thin as 25 to 40 basis points -- it would make us far less competitive. Therefore, to the extent that U.S. banks operate in support of U.S. exporters, any ability to function in this role would be reduced. In fact, given the burdens H.R. 3838 imposes --including the profound complexities of required separate tax computations for every foreign loan -- smaller and regional banks might be prone to view H.R. 3838 as an inducement to abandon the international market altogether. For many regional and smaller banks, international banking is becoming a marginal business. As costs increase, it simply becomes too difficult to compete with giant foreign banks that frequently benefit from government support, if not benign noninterference. And, should U.S. banks be forced to diminish their commitment to international business, the foreign banks that fill the vacuum may well prefer to support exporters from their own countries rather than U.S. firms.

Second, it is clear that the plan would diminish U.S. banks' ability and willingness to lend to many LDCs, at the very time when the administration is urging increased U.S. bank loans to such countries.

Third -- and singling out the banking industry for unique treatment in this area -- H.R. 3838 would tax currently passive income earned by U.S. banks' foreign subsidiaries, regardless of whether such income has been remitted to the United States. This would add a further unjustified burden to the costs of doing international business -- with predictable impacts on competitiveness -- as well as being highly discriminatory.

But by far, H.R. 3838's biggest problem is its treatment of tax bad debt reserves; and the remainder of these remarks will focus on this overriding issue.

As mentioned earlier, H.R. 3838 permits some banks -- those with less than $500 million in assets -- to retain the current deduction for additions to the tax bad debt reserve. For banks with assets above that arbitrary cutoff point, all tax bad debt reserves are eliminated, and existing tax reserves must be taken back into taxable income over a five-year period.

As you know, the House Ways & Means Committee originally rejected any elimination of tax bad debt reserve accounting. It adopted a measure permitting banks to deduct additions to the tax bad debt reserve to the same extent as the proportion of book bad debt reserves* to eligible loans, with a ceiling of

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*The phrase "book bad debt reserve" is used for simplicity, although the more common term is "book loan loss reserve."

1.5%. In doing so, the Committee properly recognized that such accounting is appropriate tax policy and is supportive of important regulatory policy concerning book reserves for bad debts. Given the emphasis on safety and soundness in the banking system, such support appears highly desirable as a public policy matter.

However, the Committee ultimately decided, in a second controversial vote, to adopt the Treasury's proposed elimination of tax bad debt reserve accounting, with an exception granted to the smaller banks. It is hard to understand how the Committee rationalized this. If it really believed that tax bad debt reserves were wrong, then why allow the 14,000 banks with less than $500 million in assets to continue using them? And if, on the other hand, it realized that tax bad debt reserves fulfill a useful purpose, then why eliminate them for some 500 larger banks? More fundamentally, the Committee's second vote was an unfortunate decision in that it perpetuated a total misconception as to the nature of tax bad debt reserves.

Essentially, deductions for additions to a bank's tax reserve reflect losses *inherent* in the portfolio at any point in time. The importance of that word -- "inherent" -- cannot be overstated. It does not mean "future." It does not mean "anticipated." It means existing, real losses. Like the

Treasury Department proposal before it, H.R. 3838 does not reflect this distinction. It apparently accepts the Treasury's earlier dictum that "the deduction for the increase in the tax reserve represents a deduction for future loan losses."

This is simply wrong. The tax bad debt reserve, and deductions for increases to it, do not reflect future losses. The economic loss inherent in the portfolio occurs much earlier than the actual date of write-off. The writing off of a loan occurs only at the end of a very long process of asset deterioration. Thus, H.R. 3838, which assumes that the assets of large banks are undiminished in value until the moment they are actually written off, would not tax banks on their true economic income. Yet this is tax reform's purported aim -- to measure and tax real economic income more accurately and fairly.

Surely it is noteworthy that everyone engaged in evaluating bank soundness and profitability looks carefully at bad debt reserves. Bankers, regulators, accountants and analysts alike recognize that asset quality deterioration occurs long before actual writeoffs are booked. In fact, the Securities and Exchange Commission requires that a registered bank holding company prepare its financial statements in accordance with generally accepted accounting principles and have those financial statements certified by its independent public accountants. In order for the CPAs to issue a clean or unqualified opinion, they must follow the guidance set forth in the American Institute of Certified Public Accountants' Industry Audit Guide, Audits of Banks. This accounting requirement states that the book reserve for bad debts must be adequate to cover estimated losses inherent in the loan portfolio. Thus, under GAAP, the reserve is for losses that are there at present, not in future.

Clearly, the SEC and the accounting profession recognize the concept of inherent loss in the portfolio. The question that arises with H.R. 3838 is why it accepts the concept for small banks but rejects it for large ones. It seems to be obvious to virtually all observers that loan losses do not happen overnight; but, while obvious, this point merits some attention in view of the confusion evinced by H.R. 3838.

A loan is extended because a company or concern needs credit for a given purpose, whether it is permanent financing or working capital for manufacturing farm equipment, drilling an oil well, constructing an apartment building, building a new plant, or planting crops.

Assume that the loan is for farming, and the farmer hits a streak of bad luck, such as a crop failure or export difficulties beyond his control. The farmer begins to experience losses, and if his luck does not turn around quickly, the value of the bank's loan has decreased. The possibility exists that the bank may not be paid back. However, let us assume that the farmer struggles on. His losses mount up over the next six to twelve months. During this period, the value of the loan -- and the probability of repayment -- dwindle. Finally, the farmer stops paying interest on his loan in order to conserve cash for seed purchases or other capital expenditures related to the next crop -- which he hopes will put him back on his feet. Assuming these hopes are not fulfilled, the value of the loan diminishes further. The chances of ultimate repayment are even lower.

At last, two years after the loan was initially made, the farmer files for bankruptcy. His assets are sold and the bank recovers 25¢ on the dollar. The question is: when did the 75¢ loss on the dollar occur? Certainly not at the very end. But this is the very point that has been totally missed by H.R. 3838 and the Treasury Department before it.

And yet this point is not particularly obscure. A bank has myriad loans on its books, and even with the best credit analysis in the world, it is impossible to know in advance exactly which loans will go bad and which will not. For that reason, a general provision is made each accounting period to accrue for such losses. This loss recognition concept makes sense not only because of the ease of applying the method to huge numbers of loans on a bank's books, but also because it reflects the economic reality of declining loan values as they occur. In any bank's portfolio, the losses are there, but it is impossible to pinpoint exactly where and when "the" loss has actually occurred. Losses are slow deaths, as we have seen all too painfully over the last few years. Losses in the farm community or in the energy sector have not occurred in a year, but have built up over a substantial timeframe. Precipitate bankruptcies are the exception, not the rule. The more typical loss occurs slowly, but is no less real for that. This is true for large and small banks alike. The tax code should recognize this reality.

Put another way, in order to properly measure income, it is essential to estimate the decline in value of a corporation's operating assets as its productive capacity is used up. A manufacturer currently does this through a depreciation deduction, while the depreciating machinery is still being utilized. If depreciation were eliminated, the manufacturer could recognize a loss only when the machine was fully utilized or depreciated; the loss would be the difference between his cost and the sale or scrap value of the used machinery. But no one suggests eliminating depreciation and forcing manufacturers to wait until they scrap or sell their used equipment before being allowed to take a deduction. Yet, for a bank, the losses inherent in the portfolio are largely analogous to the diminishing value of machinery used in manufacturing; and H.R. 3838 does propose to eliminate the functional equivalent of a depreciation deduction.

Therefore, we think that in addition to being substantively erroneous, H.R. 3838 is doubly discriminatory. To treat one class of banks differently than another simply because of their asset size -- when asset size is irrelevant to the policy issue -- is patently unfair. More broadly, to insist on deductions only after writeoffs occur treats financial assets punitively relative to capital assets. Thus, the banking industry is being held to a different depreciation standard than others. Unless there is some valid public policy rationale for such discrimination, it cannot be defended. Nor, once the distinction between future and inherent loss has been understood, can the overall elimination of tax bad debt reserve accounting be justified.

It would almost appear that the House Ways & Means Committee failed to place the tax treatment of bank bad debt reserves in its full context. Even if the broader framework of overall tax policy was considered, it is clear that insufficient attention was devoted to the context of the financial system: the safety and soundness of the banking industry and the very real relationship between providing for tax bad debt reserves and book bad debt reserves.

In a financial system that has experienced a number of systemic shocks, one predictable reaction of the banking regulators has been to focus on bank capital. Although it is not the only factor involved in safety and soundness, capital continues to be viewed as a buffer against unexpected losses, and concern has focused on ensuring its adequacy to that task. Book bad debt reserves are an integral part of bank capital, and both as the first line of defense available to absorb loss and in their more generalized role as part of capital, their augmentation has generally been deemed desirable as a matter of safety and soundness. Clearly, policies that act to reduce bank bad debt reserves or to discourage additions to them are inconsistent with such augmentation.

It is in this sense that H.R. 3838 is so pernicious. One of its most fundamental errors is its assumption that there is no relationship between tax bad debt reserves and book bad debt reserves. This in turn gives rise to the belief that radical changes in tax policy can be made without affecting book bad debt reserves or bank safety and soundness. In publishing their final recommendations back in May 1985, the Treasury maintained that "historically, the tax rules for computing deductions for additions to tax reserves have been unrelated to reserve requirements imposed by regulatory agencies. Under current law, deductions for additions to a bad debt reserve do not reflect additions to actual reserves, only a reduction in tax liability." This assumes that a relationship could exist only if tax rules and regulatory rules were specifically and formally designed to operate in perfect tandem. Today, it is true that book and tax bad debt reserves are not linked in this one-to-one sense. But that doesn't mean they have no correlation. It is therefore essential to probe further and ask two critical questions: what would be the real-world impact on bank safety of eliminating tax bad debt reserves? And what would be the impact on bank behavior and practice?

With regard to the first question, there is a very real connection between tax bad debt reserves and bank safety. To put it succinctly, the elimination of tax bad debt reserves -- particularly as proposed by H.R. 3838, with its "clawback" provision adding current tax reserves to taxable income over five years -- would entail a huge drain on cash flow and earnings within time. This would directly translate into reduced bank capital.

As for the likely behavioral impacts, it is worth recalling that the deduction for additions to the tax bad debt reserve does provide a cash flow benefit that can, in some ways, mitigate the impact of adding to book bad debt reserves. As you will recall, additions to the book reserve are taken out of pre-tax earnings. Clearly, the _a priori_ incentive to decrease earnings in order to add to the book bad debt reserve is likely to be minimal. Of course, prudence dictates a certain reserve level; but all other things being equal, one would have to say that, given shareholder and other external pressures, there is no great incentive to add to these reserves out of earnings. Removing the mitigating impact of the tax bad debt reserve, and replacing it with an incentive to write off instead of providing for losses, would have obvious results.

Those results, once analyzed, appear likely to be anti-growth. Since the only way to obtain a valid tax deduction would be to write off a bad loan, banks might be expected to do precisely that, however reluctantly. The fastest way would be through bankruptcy and foreclosure proceedings. Clearly, with a borrower like the farmer cited earlier, this would obviate the need for the bank to suffer through another planting season. In fact, under the new system established by H.R. 3838, time would become the paramount concern when a loan began to go bad. In turn, trying to resolve the situation quickly could well result in greater than necessary borrower problems and a loss in economic growth.

Frequently, when a banker works with a troubled borrower, they can jointly turn a bad situation around, with the borrower consequently able to resume economic activity and expansion. Although banks would certainly wish to continue working out bad loan situations, it is undeniable that all the incentives would be pushing them in an entirely different direction.

There are other negative practical implications of H.R. 3838. For example, what would happen to earnings and stockholders if, as the bill prescribes, tax bad debt reserves were entirely removed and tax deductions could be taken only at the time of actual writeoff -- using the depreciation analogy, when the machinery is actually scrapped? This would entail a time lag between the time when actual loan losses are sustained and when any mitigating tax benefit resulting from a consequent deduction would be obtained. This time lag would entail very negative impacts on a bank's cash flow. Who would feel those negative impacts? Obviously, shareholders, whether in the form of lower dividends or lower earnings, because cash flow cannot be reinvested. It is just as clear that the beneficiary of the time lag -- the float -- would be the U.S. government, which would be receiving an interest-free loan. It is hard to understand how a tax reform program centered on fairness to the taxpayer could actually result in an increased taxpayer subsidy to government; but that is the case here.

More profoundly, at this point one would have to ask what function is being served by the book bad debt reserve. If losses are to be dealt with only as they occur, one could argue that they need not be provided for; whatever is needed can simply be taken out of capital/shareholder equity on an as-needed basis. Perhaps, if we are moving to a system in which we deal with things only ex post facto -- on the misguided assumption that all losses are by definition "future" -- then perhaps we should consider some radical regulatory changes as well.

In fact, with H.R. 3838, tax policy is departing at a 180 degree angle from generally accepted accounting principles and from sound regulatory policy. We think this is a very unhealthy situation. For all that we may disagree on the specifics of various regulatory initiatives, we concur on fundamentals -- such as that adequate bank capital and bad debt reserves should be encouraged. Tax policy that undermines such fundamentals is extremely counterproductive.

More broadly, we view the problem posed by H.R. 3838 not only as a matter of the tax code versus regulatory policy, but as a failure to place both in full and proper perspective. Both tax and regulatory policy need to be viewed as parts of a larger whole -- public policy. From this standpoint, the tax bad debt reserve is analogous to the deduction for a home mortgage. People do not buy their homes in order to get a tax deduction; they buy their homes to satisfy a fundamental need. But it is clear that the tax code deliberately encourages home ownership. Similarly, bank bad debt reserves have been deemed desirable as a matter of public policy. To the extent that the tax code encourages adequate book bad debt reserves, it functions similarly to the mortgage deduction, that is, in support of a broadly desirable policy objective. If such encouragement is to be eliminated, then logic certainly implies a questioning of the broader policy goal. If the tax bad debt reserve is dispensible, then are book bad debt reserves really essential? It is in surfacing and answering such questions that the Banking Committee's role is so important.

That much said, we have to ask: what are the alternatives to H.R. 3838?

Clearly, the simplest would be to remain with current law -- as nearly 14,000 smaller banks are permitted to do by H.R.

3838. Until 1987, under current law, banks may deduct up to .6% of eligible loans or they may elect to take a deduction based on so-called "experience" (we say so-called because that formulaic method is flawed). In 1987, under current law, the percentage approach would be dropped and the "experience" method would apply to all.

Another approach is the "GAAP" type proposal that was originally adopted and then dropped by House Ways & Means. Under that approach, banks could calculate the deduction in accordance with generally accepted accounting principles (GAAP), taking an annual tax deduction for bad debt reserve additions up to, but not exceeding, 1.5% of eligible loans, even if the book reserve was greater. Perhaps most important, this approach would address the Treasury's complaint that the present system permits banks to take tax bad debt reserve deductions in excess of their additions to the book bad debt reserve. Under the GAAP approach, deductions for additions to the tax bad debt reserve would have to conform to identical additions to the book bad debt reserve, subject to the maximum cap. The relationship between book and tax reserves would be clearly established, and the beneficial impact of tax bad debt reserves on book bad debt reserves would be preserved.

The "GAAP" approach has received strong endorsement from the accounting profession and is considered by most experts to be both equitable and conducive to a constructive relationship between tax policy and regulatory goals. If it is viewed as excessively generous, there is latitude for changing it as a matter of degree -- for example, in reducing the percentage -- rather than jettisoning the entire concept.

At a minimum, should poor policy prevail and H.R. 3838 become law, we strongly urge that the "clawback" provision be deleted. It is purely punitive -- and as much an example of ex post facto law as the infamous "depreciation recapture" provision was. Like the recapture provision, it is impossible to justify in terms of public policy or simple equity. Tax bad debt reserves have been created in good faith under existing law. While understanding the urge to generate revenues in order to achieve overall revenue neutrality, the application of ex post facto law, in our opinion, is a public policy negative strongly outweighing any short-term gains. And, if this provision is retained, it would simply add another facet to an indefensible discrimination against the banking industry as against other sectors of the American economy. We strongly believe that such prejudice should not characterize a tax reform effort undertaken in the name of greater fairness.

In fact, if viewed in full context, H.R. 3838's tax bad debt reserve provisions are clearly punitive. H.R. 3838 also eliminates the ability banks presently have to deduct 80% of their interest costs in carrying tax-exempt municipal bonds. Today, bank taxes superficially appear low, largely because of their municipal investments; however, since the benefits of those investments — in the form of lower yields -- are passed along to municipal issuers, the real tax rate paid by banks is appreciably higher.

The low so-called "effective tax rate" of many banks is no more than a reflection of the fact that they are so heavily invested in tax-exempt municipal bonds. Remove or discourage that investment, and banks will have far greater taxable income and far higher tax rates. To get an idea of what those levels of tax would be, all that is needed is to look at banks' fully equivalent tax rates — that is, the tax rates they would show right now if they were invested in taxable, rather than tax-exempt, instruments. For example, Morgan Stanley's banking analyst calculated a fully equivalent 1984 tax rate of 50.5% for money center banks. If we add to this the very real, if indirect, tax paid to the Treasury in the form of forgone interest on reserves held by the Federal Reserve -- quantified at $2 billion annually some years ago -- it is clear that bank tax rates already measure up more than adequately to those of other industries.

Given this picture, it is equally clear that eliminating the cost-to-carry deduction, with its concomitant impact on bank investment decisions, would likely result in dramatically higher "effective tax rates." While we continue to believe that our "real" tax rate today is in line with other industries, once the facts of intermediation and non-interest-bearing reserves are understood, others may refuse to acknowledge these factors. But even they would find it hard to deny the higher rates that could result from H.R. 3838's cost-to-carry provisions and other changes affecting bank-intermediated tax benefits, such as leasing. And, should such rates become substantially higher, the tax bad debt reserve provision's additional impact would be manifestly Draconion. Instead of resulting in bank tax rates aligned with those of other industries, it would result in bank tax rates considerably higher than those of other industries.

In summary, H.R. 3838's treatment of bank taxation simply does not qualify as "tax reform" in the sense intended by most proponents. On the basis of erroneous assumptions, it deals with the banking industry in a punitive and arbitrary manner. More broadly, it undermines both major policy initiatives and key financial policy objectives. As such, H.R. 3838 is highly counterproductive to the goal of a healthy and competitive banking industry, and can therefore be expected to have negative implications for the economy as a whole.

TESTIMONY OF
THE COALITION OF SERVICE INDUSTRIES
SUBMITTED TO
THE SENATE BANKING COMMITTEE
FEBRUARY, 1986

The Effects of Proposed Tax Reforms on the International Competitiveness of U.S. Industries

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The Coalition of Service Industries appreciates this opportunity to comment on the effects of proposed tax reforms on the international competitiveness of U.S. service businesses.

We find certain provisions of the tax reform bill reported by the House of Representatives to be particularly injurious to American service industries with operations abroad.

The service sector is the backbone of the U.S. economy and has consistently reported a surplus in the balance of payments, keeping our national trade deficit from becoming even worse. The foreign tax provisions contained in the House Ways and Means Committee bill represent a radical change in the historical U.S. tax treatment of foriegn income, have not been the subject of any hearings, discriminate against U.S.-owned international service businesses, and have a dramatic detrimental impact on the ability of such businesses to compete in foreign markets.

I would like to just briefly go through some of the major provisions we oppose.

The foreign tax provisions of the bill represent a radical reversal of generations of federal tax policy, which have never been the subject of Congressional hearings. There has been no evaluation of these proposals for their technical correctness or for their anticompetitive trade implications on U.S. service companies. Further, these options inexplicably discriminate against service firms. Because service firms tend to follow their customers overseas, hampering their expansion will have an adverse ripple effect throughout the U.S. economy. For instance, it will curtail the foreign lending capabilities of U.S. banks needed to finance U.S. exports or the ability of the U.S. to maintain a viable merchant fleet.

These changes could not come at a more inappropriate time. The 1984 Trade and Tariff Act mandated parity of treatment between the services and goods sectors in order to enhance the export of services. Now, our government's effort to organize trade in services through the GATT will be undermined by this tax counterpolicy.

The international service business follows its clients overseas to service them. For example, a manufacturing company opening a new plant in a foreign country will require local insurance services and will look first to its U.S. broker and insurer to meet those needs. In this fashion, the U.S. broker and insurer seek to retain the totality of their client's worldwide business.

Foreign laws and regulations generally restrict trade in services and require service businesses to make a direct investment in the country in which they wish to offer their services. This is the reason, therefore, that international service businesses often have many more foreign subsidiaries than manufacturing firms. This pattern of following one's clients overseas indicates that service businesses do not have the flexibility to pick target countries purely because they may be low tax. In fact, taxes usually are not a consideration at all.

The foreign tax provisions of this bill are far reaching, especially as they affect Subpart F, the foreign tax credit, the allocation and apportionment of deductions for the foreign tax credit computation, and the source of income rules. These provisions have been the pillars of the U.S. tax structure governing the foreign investment and activities of U.S. tax payers. They were designed in part with a view to keeping U.S. taxpayers competitive in the international marketplace. Inexplicably, these provisions make changes that are detrimental to just one segment of the economy -- international service businesses. Quite simply, these provisions will make it impossible for some companies to operate in foreign countries.

The Subpart F provision, by including certain active business income, amounts to a repeal of deferral for many U.S.-owned foreign banking, financial, shipping and insurance corporations. Congress has repeatedly upheld the policy that active business income should not be subject to current taxation until actually repatriated to the United States. All industrialized countries recognize deferral for overseas active business income. Without it, U.S. companies will be less competitive than their foreign counterparts. Without question this repeal of deferral discriminates against a significant sector of the service economy.

But if repeal of deferral is death for many businesses, the separate foreign tax credit limitation for low-tax/high tax income of service companies is worse than death. Any departure from the overall limitation, well established in existing law, will result in the inability of U.S. service companies to "average" their highly taxed foreign income against lightly-taxed foreign income. This proposal will impair the ability of U.S. companies to compete in those countries imposing a high rate of corporate income tax. In considering alternatives to the overall limitation, the staff apparently rejected the "per-country" method as too complex. The "low-tax" income option in effect adds "per-item" complexity to "per-country" and the result must be complexity squared. Congress decided wisely the last time around that only the overall limitation with retention of deferral makes sense in an internationally, interconnected, and intercompetitive world.

In another section of the bill, the proposed modification to the expense allocations rules overturns decisions arrived at after 12 years of Treasury Department and industry negotiations of a complex issue. By generally increasing expenses allocated to foreign source income, coupled with the proposed changes to Subpart F and "low-tax" basket limitations, the value of the foreign tax credit will be severely cutback resulting in U.S. corporations being burdened by double taxation.

Further, by changing the source rules in significant respects, the Committee is creating many new situations of potential double taxation. The Committee should adopt an expanded version of the President's proposal to eliminate double taxation in the area where construction services are rendered in the U.S., but the country that uses or consumes them taxes its payments at the source of payment. An election to deduct or use a source rule similar to the rule applied to royalty income is recommended for an expended category of highly technical services rendered in the U.S. but used and taxed overseas. The U.S.' failure to do so will just encourage those operations eventually to move overseas.

Two of the Committee's options are specifically anti-export. Instead of reducing the FSC benefit after only one year of availability, the Committee should expand the FSC to include additional services, consistent with Congress' overall trade policy. The proposal to reduce the current $80,000 exclusion of income earned abroad to $50,000 and include the excluded income in the individual minimum tax base is contrary to trade policy which should be designed to encourage Americans to make the sacrifices attendant with employment in a foreign country.

The Coalition has carefully studied this legislation and it is our conclusion that, if it is the policy of this government that U.S. businesses remain competitive abroad, the foreign tax provisions must be removed.

Service businesses already face tremendous obstacles to fair competition in foreign markets. Imposition of yet another barrier in the form of burdensome tax laws -- a barrier erected by the U.S. government -- will throttle the momentum of the United States service sector abroad and render uncompetitive that one positive account in an otherwise dismal balance of trade.

3900 Wisconsin Avenue NW
Washington DC 20016
202 537 6770

David O. Maxwell
Chairman of the Board and
Chief Executive Officer

FannieMae

February 11, 1986

The Honorable Jake Garn
Chairman
Committee on Banking, Housing and
  Urban Affairs
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

I appreciate the opportunity to comment for the record on H. R. 3838, the House-passed tax bill. I will elaborate somewhat on the two issues I raised in my January 15 letter to you.

First, I want to address what I see as the effect of the proposed tax changes on multifamily housing, particularly for moderate-income families. I am aware that the National Association of Home Builders (NAHB) and others have described to the Committee the significant increases in rents that will be necessary to incent developers to build rental units with the new depreciation rules. Despite slightly more beneficial depreciation treatment for lower-income developments, I am concerned that the House-passed changes will seriously retard the building of apartments for lower-income families.

I support targeting the benefits of tax-exempt financing to those most in need. However, I believe the House-passed tax bill goes well beyond that and will actually reduce the construction of legitimate low- and moderate-income developments.

We have already noticed the effect of these changes at Fannie Mae. We offer a credit enhancement product for multifamily housing financed by tax-exempt bonds. Our credit enhancement product, which the Congress specifically included in the 1984 tax legislation, helps reduce the rates that state housing finance agencies (HFAs) must pay to issue bonds. These savings flow directly to the residents through lower carrying costs. During 1985, Fannie Mae completed $1.8 billion in credit enhancement business.

The 1985 book of business was dominated by second half activity as HFAs rushed to issue bonds before the new rules took effect. While some slackening in activity is to be expected given the volume issued in the second half of 1985, our contacts with the HFAs indicate that the new rules in H. R. 3838 -- if passed -- will permanently reduce the volume of tax-exempt issues for moderate-income apartments. In that regard, I am mildly encouraged by Chairman Rostenkowski's recent statement that he could agree to some extension of the effective dates for tax-exempt bonds.

In light of the sharp reductions in the HUD budget for housing subsidies, it seems to me unwise to restrict even further the options low- and moderate-income families have by limiting the volume of tax-exempt bonds that can be issued to finance apartments. Housing has absorbed a substantial share of cuts through the budget process; it shouldn't have to give again at a different office.

The second issue I raised in my letter is the tax treatment of financial institutions. Thrifts should retain an incentive to invest in housing through the tax code. And, Congress recognized that all financial institutions should have a different carryback/carryforward treatment because of the effect of interest rate movements on financial intermediaries. H. R. 3838 makes adverse changes in these important incentives.

Fannie Mae does not have a special bad debt reserve, but thrifts do under Section 593 of the Code. Section 801 of H. R. 3838 would essentially emasculate Section 593 in the interest of "greater competition." The technical compilation accompanying the House bill explains that a lower percentage deduction (5% instead of 40%) is warranted because thrifts have more powers. Unfortunately, this is consistent with the recent CEA report that says that a specialized thrift industry is no longer necessary. Both are dead wrong.

The 1982 Garn-St Germain Act gave thrifts more powers so they could regain their financial health and continue their long-standing commitment to mortgage finance. H. R. 3838 seems to stand logic on its head by now saying that thrifts only need a relatively minor incentive to remain mortgage lenders. In part, our housing finance system depends on providing tax incentives to lend on residential housing. As with user fees, which I discussed with you recently, this is just another example of a non-housing committee deciding what housing policy should be. This authority rightly belongs in both Banking Committees. It is true that the bad debt deduction is a tax incentive, but its virtual elimination should not even be considered -- much less passed -- without the Finance Committee receiving your advice.

The second tax change -- changing the carryback/ carryforward rules -- makes no sense. Fannie Mae is affected by this change as are thrifts and commercial banks. The only reason the Ways and Means Committee gives for making this change is that: "The Committee believes that net operating losses incurred by financial institutions such as commercial banks and thrift institutions should be treated in the same manner as for other taxpayers."

This is pretty flimsy because it is not backed up by any study or analysis. And, financial institutions are just not like other taxpayers. The government has long recognized this by setting up special regulatory systems, more limited powers and special tax rules. Interest rate cycles affect financial institutions much more significantly than industrial companies because the main product of the former is money, i.e., the intermediation of that money from investors to borrowers. The special carryback/carryforward rules recognize this distinction. And, they don't cost the Treasury any money over the cycle. The compilation of H. R. 3838 states that changing this rule "is estimated to increase fiscal year budget receipts by less than $5 million annually."

Since the existence of the current rules costs virtually nothing, and since the effect of the new rules could be damaging, I suggest that this item be deleted entirely from any tax bill that is enacted.

Thank you for considering my viewpoint on these two issues, and I appreciate your making this letter a part of the record. Again, I commend you for leading the Committee in considering the effects of all the changes in H. R. 3838 on housing and financial institutions. Please let me know if I can help you further in any way.

Sincerely,

David

DOM/cfb

FEDERAL DEPOSIT INSURANCE CORPORATION

OFFICE OF THE CHAIRMAN

February 5, 1986

Honorable Jake Garn
Chairman, Committee on Banking,
 Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

The FDIC would like to comment on two tax-related provisions that are of particular importance to the safety and soundness of the banking system and to the security of our deposit insurance fund. We would appreciate it if the following comments could be made a **part of the record of your hearings presently being held on the effect of tax reform on the banking industry**.

The FDIC's first concern is the termination of the bad debt reserve deduction for large banks, i.e., banks with assets of more than $500 million. H.R. 3838 retains present law regarding the use of bad debt reserves by small banks.

Based on the FDIC's experience with examining both large and small banks, we have concluded that discouraging use of bad debt reserves is not consistent with the economic results of a bank's current operations.

The size of a bank's loan loss allowance figure has real significance. The need to add comparatively large amounts can have undesirable consequences because increases reduce reported earnings and net worth. A publicly owned bank or bank holding company that has to make material increases to its allowance could see the market price of its outstanding securities fall and the cost of its purchased money rise. A publicly or closely held bank could be required by its Federal bank supervisor to raise additional capital and adopt appropriate plans to improve the loan portfolio, which may result in the bank's board of directors dismissing the senior loan officials.

Taking the reserve method away from large banks does not eliminate a preference. Rather it denies deductions for one of the most significant expenses that banks are presently incurring and weakens the safety and soundness of many institutions in an industry that already has more than its share of troubles. Because of the FDIC's concern for the safety and soundness of individual banks and the continued viability of the industry, I, therefore, strongly recommend that you do not discontinue the reserve method for banks.

The FDIC's other concern relates to the current disparity in federal tax treatment of financial assistance given by the FDIC as compared with that provided by the Federal Savings and Loan Insurance Corporation (FSLIC).

Currently, under Section 597 of the Tax Code, assistance given in reorganizations of financially troubled thrift institutions by the FSLIC is tax free. This status for FSLIC assistance was enacted as part of the Economic Recovery Tax Act (ERTA) of 1981. Unfortunately, FDIC assistance to financial institutions it insures was not specifically included at that time. The FDIC believes that this oversight should be corrected since assistance payments to and reorganizations of troubled financial institutions by the FSLIC and the FDIC are basically identical.

Although H.R. 3838, as passed by the House, would delete this assistance, effective January 1, 1986, the President's Tax Reform Proposal (Chapter 10.04) recommends that the special tax treatment of FSLIC assistance and reorganizations be continued through 1991. We support this extension, and suggest that, in the interim, the Code should be modified to make clear that FDIC payments to financial institutions are likewise not subject to tax.

Your support for bringing about an equalization in the treatment of FSLIC and FDIC assistance, as tax reform legislation works its way through Congress, would be greatly appreciated. Such a result would be of substantial benefit to the FDIC as it seeks to resolve problem cases in the most cost-effective manner possible. Draft language accomplishing this result is attached.

Thank you for your consideration of these comments.

Sincerely,

L Wm Seidman

L. William Seidman
Chairman

Enclosure

Section 597. FINANCIAL ASSISTANCE

(a) EXCLUSION FROM GROSS INCOME -- Gross income of a bank as defined in Section 581, a mutual savings bank including a bank with capital stock as defined in Section 591(b), a cooperative bank, and a domestic building and loan association, does not include any amount of money or property received from the Federal Savings and Loan Insurance Corporation pursuant to Section 406(f) of the National Housing Act (12 U.S.C. § 1729(f)), or from the Federal Deposit Insurance Corporation pursuant to Sec. 13 of the Federal Deposit Insurance Act (12 U.S.C. § 1823), regardless of whether any note or instrument is exchanged therefor.

(b) NO REDUCTION IN BASIS OF ASSETS -- No reduction in basis of assets of a bank, mutual savings bank, cooperative bank or domestic building and loan shall be made on account of money or other property received under the circumstances referred to in subsection (a).

New language underscored

Federal Home Loan Bank Board

EDWIN J GRAY
CHAIRMAN

1700 G Street N.W.
Washington D.C. 20552

Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

February 12, 1986

Senator Jake Garn
Chairman, Committee on Banking
Housing and Urban Affairs
534 Senate Dirksen Office Building
Washington, D.C. 20510

Re: Hearings on tax bill. H.R. 3838

Dear Senator Garn:

It is crucial to the Federal Savings and Loan Insurance Corporation, and to public confidence in the nation's financial institutions, that any tax reform retain the existing tax provisions which facilitate supervisory mergers and conversions of failing thrift institutions. These provisions of the Internal Revenue Code are: Section 368(a)(3)(D)(ii) (taxfree reorganization treatment of supervisory thrift mergers): Section 382(b)(7)(B) (net operating loss carryovers in taxfree supervisory mergers); Section 597 (FSLIC assistance not taxable); and Section 593(e)(1) (no recapture of bad debt reserve when FSLIC assistance is repaid).

We urge the following:

1. The FSLIC tax provisions should be continued in effect and not repealed. Section 804(a) and (b) of H.R. 3838, which repeal the FSLIC provisions, should be rejected.

2. Supervisory thrift mergers and conversions should be excepted from the proposed new revision of restrictions on net operating loss carryovers under section 382 of the Internal Revenue Code. (Section 321, H.R. 3838.)

3. IRC section 265(1) should not apply to thrifts which receive FSLIC assistance. This Code section disallows deductions for expenses "allocable to" receipt of tax-exempt income. Section 804(c)(2)(B) of the House bill contains such a clarification, but only for 1981 through 1985. This provision of the House bill is sound, and should apply for the entire period during which the FSLIC tax rules are continued, and

4. The taxfree reorganization category should be undated to cover supervisory conversions (as well as mergers) of troubled thrifts.

Repeal of the FSLIC tax rules will have a devastating effect on the Federal Home Loan Bank Board's ability to arrange supervisory mergers and will lead to enormous strains on the insurance fund. The practical effect will be to dramatically reduce the number of potential acquirers and increase the cost to FSLIC for those still willing to acquire defaulted institutions. For example, in some recent negotiations, potential acquirers are already asking FSLIC to indemnify them for the increased tax liabilities that will arise if the merger and FSLIC assistance became taxable. The transaction might also become legally impossible, because the cost of assistance could exceed the cost of liquidation. By law, in that event the institution would have to be liquidated.

No tax abuses occur under the FSLIC tax rules. Only savings and loan associations can use another association's loss carryovers from a pre-merger year. In FSLIC arrangements tax benefits realized by an acquiring association benefit FSLIC by reducing future assistance obligations.

The House tax staff's estimate of revenue increases from repealing the FSLIC rules -- $1.3 billion over 1986-1990 -- is completely illusory. Acquisitions will practically cease to occur. Tax revenues will then not arise at all. In fact, liquidating payments will increase and, since the full faith and credit of the United States implicitly backs the insurance fund, ultimately cost the Treasury more than the cost of continuing the existing tax rules.

A more detailed statement of our views on H.R. 3838 is enclosed.

Sincerely,

Edwin J. Gray
Chairman

Donald I. Hovde
Board Member

Mary A. Grigsby
Board Member

Federal Home Loan Bank Board

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

February 14, 1986

Senator Jake Garn
Chairman, Committee on Banking
Housing and Urban Affairs
534 Senate Dirksen Office Building
Washington, D.C. 20510

Re: H.R. 3838 (Proposed Tax Reform Act of 1985)

Dear Senator Garn:

This statement is submitted for inclusion in the record of your Committee's hearings on February 4-6, 1986, covering provisions of H.R. 3838, the proposed Tax Reform Act of 1985, which affect financial services.

We call your attention to the essential role certain tax rules play in assisting government-supervised mergers of defaulted savings and loan associations. These mergers typically involve acquisitions of insolvent or troubled associations by healthy institutions capable of solving the problems and maintaining the confidence of depositors in the troubled entity. These mergers occur under the supervisory authority of the Federal Home Loan Bank Board (FHLBB) and the Federal Savings and Loan Insurance Corporation (FSLIC) to safeguard and maintain the federal deposit insurance program. This program has long protected savings and loan institutions and, most importantly, the funds which depositors have placed in those institutions.

Section 804 of H.R. 3838, the tax bill passed by the House of Representatives on December 18, 1985, would repeal the special tax rules covering these supervisory transactions. However, repeal will not increase federal tax receipts. Instead, if repeal occurs, the negative tax results of an acquisition will discourage potential acquirers from agreeing to acquire troubled institutions in the first instance. This will in turn lead to more liquidations of ailing associations and to increased payments of deposit insurance. The enormous strains which the FSLIC insurance fund already faces will be aggravated. Such strains from the tax side are not only completely unnecessary. They would be both counterproductive and, indeed, destructive.

It is crucial to the viability of the deposit insurance fund, and to overall public confidence in our financial institutions, that any tax reform retain the existing tax provisions which facilitate supervisory mergers and conversions.

This statement sets forth detailed comments on the specific tax provisions which should be continued. We also believe that several clarifications and amendments to the existing tax rules should be made, as described further below.

INTRODUCTION

The special FSLIC tax provisions were enacted as part of the Economic Recovery Tax Act of 1981. This legislation adopted several statutory provisions which address the taxfree reorganization of troubled thrifts; clarify net operating loss carryover rules; exclude from income financial assistance supplied by FSLIC to weakened thrifts; and liberalize the rules concerning the effect on asset basis when FSLIC contributes to the capital of a weakened institution. These provisions in existing tax law are as follows:

> Section 368(a)(3)(D)(ii) of the Internal Revenue Code provides basic taxfree treatment for supervisory thrift mergers.

Section 382(b)(7)(B) treats depositors as shareholders for purposes of applying net operating loss carryover limitations to supervisory thrift mergers.

Section 593(e)(1), last sentence, prevents recapture of bad debt reserves when an assisted institution repays FSLIC.

Section 597 excludes FSLIC financial assistance from taxable income of the recipient association, and no writedown is required in the tax basis of assets of the association.

The proposed repeal of the FSLIC tax provisions would be effective for supervisory mergers or acquisitions occurring on or after January 1, 1986, and for FSLIC assistance payments received in taxable years of an association beginning on or after January 1, 1986. No public hearing was held in the House tax committee to support this repeal, or even to gather facts on current conditions affecting the deposit insurance fund.

In fact, the need for the tax provisions is greater now than it was in 1981. The President's Tax Reform Plan proposes to continue all these FSLIC rules at least through December 31, 1990. This continuation is critically important to the thrift industry.

In our opinion, section 804 of the House bill will have a devastating adverse effect on the FSLIC insurance fund, and on the industry it insures, at a critical phase in the history of our national thrift system. In proposing to continue these provisions, the President recognized that "the thrift industry has not fully recovered from the economic conditions which prompted Congress to enact the special reorganization rules in 1981."1/ This is particularly true now. We solicit your help in retaining the FSLIC provisions of

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1/ The President's Tax Proposal to the Congress for Fairness, Growth, and Simplicity, pp. 249, 251 (May 1985).

existing tax law.

As regulators, we have taken numerous steps to relieve pressures on the insurance fund apart from tax rules. The Board has, among other actions, issued regulations which effectively require increased capital for thrift institutions and which exact substantially greater control over certain risky investments. The Board has also exercised its authority to its fullest extent under law by increasing in 1985 the FSLIC assessment on insured institutions an additional 1/8 of 1% of insured deposits. The tax rules are a vital part of our total effort.

The current tax treatment afforded thrift supervisory mergers (and contributions by FSLIC to weakened institutions) provides a highly cost-effective means for avoiding liquidations of institutions, reducing the current pressure on FSLIC's financial resources, and protecting depositors. These mergers (and conversions from mutual to stock form with infusions of private capital) allow the Board to resolve problem cases at costs significantly less than the cost of liquidation and with minimum disruption to depositors. The legislative history of the FSLIC tax provisions provides abundant evidence that Congress specifically wanted to encourage supervisory mergers and capital infusions to avoid liquidating payouts.[2]

By statute, FSLIC assistance in a particular case may not exceed the cost of a liquidating payout of insurance. See 12 U.S.C. § 1729(f)(4)(A). A failing thrift would thus have to be liquidated in a case where the cost of assistance will exceed the payment of insurance on all insured accounts. During the period from January, 1980, through December 31, 1985, FSLIC arranged assisted mergers at a cost to FSLIC of about $4.5 billion (in terms of the present value of assistance to be given over future years after the mergers). This dollar figure contrasts with the estimated present value costs, developed by the FSLIC staff, of liquidating those institutions (if no merger had been arranged) of about $15 billion. The fund was thus able to save an estimated $10.5 billion by negotiating supervisory mergers rather than making liquidating payouts to depositors of the troubled institutions.

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[2] For Congressional statements as to the policy underlying the FSLIC tax provisions, see the Attachment to this letter.

The House tax bill will eliminate many if not most potential acquirers willing to work with the Board on supervisory transactions.[3] The result will be a drastic increase in costly liquidations. This will in turn place the insurance fund under substantially greater stress than it already faces. In candor, the House bill, were it to be enacted in its present form, would be nothing short of catastrophic for the future of the FSLIC. Liquidations -- the most costly way of resolving FSLIC cases -- would replace less costly assisted mergers as the only real means of dealing with such problems. Again, this would severely exacerbate the enormous strains on the FSLIC fund which already exist. In some pending negotiations, potential acquirers are asking FSLIC to indemnify them for the increased tax liabilities that will arise if the merger and FSLIC assistance became taxable. If FSLIC were to agree to compensate for these tax liabilities and loss of tax benefits, the drain on the fund will be accelerated further. An assisted transaction could well become legally impossible because the cost of assistance could then exceed the cost of liquidation.

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[3] Potential buyers will be turned away by the adverse tax results if an acquisition, and FSLIC assistance, become taxable. If the merger becomes "taxable," the acquirer (1) must recapture the acquired association's earlier bad debt reserve deductions; (2) the acquired association's past tax history, including loss carryovers, will be wiped out; and (3) a portion of the acquired association's collections on mortgage receivables taken over in the merger will be transformed into taxable income. The latter result will occur because the assets acquired in the merger will take a tax basis equal to their fair market value at the date of merger. In a savings and loan case, the tax basis of low-interest mortgages would be reduced from their original principal amounts to current market value. Collections on those mortgages after the merger will then be transformed into income (for tax purposes) when the collections exceed the tax basis in the mortgages. In reality, the collections merely reflect repayments of loan principal, not profit.

In our opinion as regulators, H.R. 3838 will devastate the weak elements of the thrift industry and further jeopardize the basic solvency of the insurance fund.

Preserving taxfree treatment, it should be emphasized, will not confer any "new" tax benefit on the parties to a merger. It will simply allow survival of the existing operating losses of the insolvent institution and of the tax basis of its existing mortgages.

SUMMARY OF BOARD'S POSITION

The following steps will help us carry out our responsibilities:

1. Continue the FSLIC provisions of existing tax law.

The special FSLIC tax provisions listed above should be continued.

2. FSLIC-supervised thrift mergers should be excepted from the proposed new limitations on net operating loss carryovers.

The tax attributes of a corporation acquired in a taxfree merger normally survive in full after the merger. However, section 382 of the Internal Revenue Code imposes special limitations on the survival of net operating loss ("NOL") and similar tax credit carryovers.[4] These restrictions apply even if the merger is taxfree to the various parties. Section 321 of H.R. 3838 would, however, totally revise the existing tax rules under section 382. The House bill would also introduce an entirely new group of limitations on unrealized ("built-in") losses reflected in assets of the acquired corporation as of the date of merger.

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[4] The limitations under IRC section 382 affect the dollar amount of carryovers that survive the merger. These limitations are to be distinguished from the time period during which loss carryovers can be used.

These proposed new restrictions will be extremely harmful to precisely the sort of portfolio rebalancing which weak elements of the thrift industry need.

If the Senate Finance Committee should adopt a similar revision of section 382, and should follow the same general approach taken in the House bill, an exception should be adopted for FSLIC supervisory mergers and conversions of FSLIC-insured institutions. The built-in loss restrictions should also not apply to assets of thrift institutions acquired in a supervisory merger.

3. Clarify IRC section 265(1).

H.R. 3838 contains a sound provision which prevents the Internal Revenue Service from denying expense or loss deductions claimed by a thrift institution which has received FSLIC assistance. Section 804(c)(2)(B) of the House bill directs that section 265(1) of the Internal Revenue Code

> "shall not deny any deduction by reason of such deduction being allocable to amounts excluded from gross income under section 597 of the Internal Revenue Code of 1954 (as in effect on the day before the date of the enactment of this Act)."

Currently, savings and loan associations can carry net operating losses back 10 years and forward 5 years. (Section 172, Internal Revenue Code.) We are not addressing here the time period during which losses can be deducted, but rather the restrictions under section 382 on the amount of loss carryovers which survive a merger of two or more thrift institutions.

This provision of the bill would clarify an interpretative question that has arisen under section 265(1) of the Internal Revenue Code, and will prevent the denial of deductions.[5]

The House bill applies this clarification retroactively to 1981. This provision of the House bill is sound; it should be applied prospectively as well, by all means.

4. Amend the taxfree reorganization provisions to apply to supervisory conversions (as well as mergers) of a troubled thrift.

The taxfree reorganization rule for supervisory mergers of defaulted savings and loan associations was drafted in 1981 before the Board began extensively to use the format of a supervisory conversion, and before Congress adopted explicit statutory criteria for such conversions in the Garn-St Germain Depository Institutions Act of 1982. Conversions have become an extremely useful technique in our arsenal of rescue vehicles.

The tax treatment of supervisory conversions is not completely clear, however, either as to basic taxfree treatment or as to the survival of loss carryovers and the tax basis of existing assets. If a converting mutual association is insolvent, or if it is not yet so weak that the Board can certify insolvency, or if its assets are not physically transferred to a different entity (as required for a taxfree type (G) reorganization), it is uncertain whether the conversion can be taxfree and whether the institution's NOL carryovers and asset basis will survive intact. Yet the Garn-St Germain Act expressly intended to encourage private capital to be infused to prevent these "early warning" situations from worsening into FSLIC receivership cases.

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[5] Section 265(1) of the tax code disallows deductions "allocable to" tax-exempt income. The legislative history of this section indicates it was intended to apply only to deductions for expenses incurred to produce or obtain tax-exempt income. See the committee reports on the 1934 Revenue Act: S. Rept. 558, 73d Cong. 2d Sess. (1934), 1939-1 C.B. (Part 2) 586, 606; H. Rept. 704, 73d Cong. 2d Sess. (1934), 1939-1 C.B. (Part 2) 554, 571.

The House provision makes clear that section 265(1) should not be used to deny deductions to a thrift institution merely because that institution has received FSLIC assistance.

To update the taxfree reorganization rules and facilitate conversions, we urge: (1) that the (G) reorganization rules for thrift mergers be amended to apply to supervisory conversions (as well as asset-transfer mergers) of failing thrifts; and (2) that supervisory conversions should be excepted from any new restrictions on NOL carryovers which may be adopted similar to section 321 of the House bill.

REVENUE ESTIMATES ILLUSORY

The House tax staff estimates that repealing the FSLIC tax provisions will increase Federal budget receipts by $1.364 billion during the period 1986 through 1990. In reality, these revenue increases are totally illusory. If repeal occurs, many if not most problem cases will not result in supervisory mergers or conversions in the first instance.

If the tax provisions are repealed, more ailing institutions will be liquidated and insurance will be paid to depositors from the FSLIC fund -- and surely, ultimately from the Treasury. The full faith and credit of the United States implicitly backs the deposit insurance fund. The predicted new revenues will simply not come into the Treasury at all. Instead, the ultimate cost to the Treasury from more liquidations will be far greater than the "cost" to the Treasury of continuing the existing tax rules.

As we noted earlier, in anticipation of losing the helpful tax provisions, potential acquirers have already begun asking FSLIC to increase its assistance to "make up" for the extra tax costs to the acquirer. FSLIC cannot afford this added drain, and many potential acquisitions will not occur because of this obstacle. FSLIC has not yet agreed to any indemnification request. If it does so, the drain on the fund will be accelerated. The total cost of the FSLIC assistance, including the indemnification, might also then exceed the cost of liquidation, and by law, as we noted earlier, FSLIC could not assist the institution.

Termination of the FSLIC tax rules could not come at a worse time. Recent interest rate declines have reduced the negative "spread" between the industry's cost of funds and yield on assets, which accounted for the record losses experienced by the industry during 1981-1982. However, the situation is in many ways worse now than during that period, because of asset quality problems that are much more expensive to resolve. This is especially true because potential acquirers tend to be unwilling, for the most part, to assume the risk of large losses on bad assets. FSLIC's need for maximum cost efficiencies is greater than ever.

Savings and loan managers are still in the process of restructuring their mortgage portfolios to avoid the huge maturity mismatches which nearly drove the industry to disaster in 1981-1982. The main difficulty now, however, is adjusting to the deregulated environment since 1982. In recent years we have seen a disturbing trend in the reasons why failing savings institutions fall onto FSLIC's doorstep. Four years ago, approximately 80% of FSLIC's cases were primarily attributable to interest rate spread problems, and 20% were primarily due to asset quality problems. In 1984 that ratio reversed itself to 30-70, with the result that a substantial portion of FSLIC's caseload is currently characterized by institutions whose problems were caused by excessively risky or unwise loans and investments. These asset quality cases have proven to be 3 to 5 times as expensive for FSLIC to resolve as cases arising from interest rate spreads.

Currently, we estimate that approximately 10 percent of thrift institutions in the country are insolvent or projected to become insolvent within the next year. The assets of these institutions are in excess of $100 billion. At least another 10 percent of savings and loan associations are on the borderline of financial trouble.

In 1984 FSLIC processed transactions involving 27 institutions with total assets of about $5.8 billion at a total cost of $1.3 billion. These figures included 18 cases with assets of $4.3 billion through assisted acquisitions. The assistance cost in those cases was $450 million. FSLIC also placed 9 institutions with assets of $1.5 billion in receivership. The cost to pay insurance in those cases was $850 million. (Before 1983 FSLIC liquidated only 15 institutions throughout its entire 50 year history.) Of the cases resolved by FSLIC during 1984, 10 were asset quality problems and only 8 were interest rate spread problems.

In 1985 FSLIC resolved 36 cases involving total assets of $6.5 billion. These included mergers at a cost to FSLIC of $450 million in assistance and liquidations at an additional cost to FSLIC of $775 million.

For 1986 through 1991 FSLIC estimates that its assistance cost for supervisory mergers will increase to $9.6 billion, plus $5.5 billion in costs of liquidating institutions that cannot be rescued. Even if we assume that we could find acquirers and that we would agree to reimburse them for additional tax liabilities, we estimate that reimbursing buyers for repeal of the special FSLIC tax provisions would cost FSLIC an additional $4.27 billion. Apart from the fact that we will not be able as regulators to approve assisted mergers of this type if the cost of assistance exceeds the cost of liquidation, FSLIC simply cannot afford this enormous further expenditure of its scarce resources.

We arrive at the $4.27 billion estimate as follows:

ESTIMATED ADDITIONAL COST TO FSLIC FOR REIMBURSING BUYERS FOR INCREASED TAX LIABILITIES, 1986-1991

1.	Taxation of FSLIC cash assistance	$ 3.17 billion
2.	Taxation of "discount income" from reducing tax basis of mortgages to fair market value	1.01 billion
3.	Recapture of bad debt reserves if mergers become taxable (rather than taxfree)	91 million
	Total	$4.27 billion

Source: Data compiled by FSLIC staff

The above total should be increased by the further cost to FSLIC if we also indemnify acquirers for the loss of existing NOL carryovers in the event that supervisory mergers become taxable.

SUPERVISORY CONVERSIONS

Under federal law FSLIC is authorized to take control as receiver of an institution which is in default, or in danger of default, and to arrange a transfer of assets to another institution in exchange for an assumption of assets and liabilities by the acquirer. The acquirer normally does not issue its own stock to shareholders, if any, or to depositors of the acquired institution. Instead, depositors in the failed institution merely receive equivalent accounts in the acquiring institution. The special thrift rule enacted in 1981 for insolvent savings and loan mergers requires that:

(a) the acquiring corporation acquire substantially all the assets and liabilities of the troubled association; and

(b) the Bank Board (or an equivalent authority) certify that the acquired association is insolvent, has suffered a substantial dissipation of assets or earnings, or is in unsafe or unsound condition.[6]

Some problem cases are resolved by means of what we describe as a supervisory conversion. These cases involve mutual savings and loan association and savings banks. Two formats are typically used: (1) a "merger conversion" in which the mutual association's assets are transferred to a different entity, which may be an existing stock subsidiary of a holding company or a newly-created stock entity; or (2) a new stock charter is issued to the mutual institution and, without transferring assets at all, the institution issues shares of its stock directly to another institution or to one or more individual investors, who agree to infuse new capital in return for the stock.

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[6] Internal Revenue Code, section 368(a)(3)(D)(ii), incorporating by reference the provisions of 12 U.S.C. § 1464(d)(6)(A)(i),(ii) or (iii).

In the merger conversion the acquiring institution may not make a lump sum capital contribution to the acquired institution at the date of merger. The acquirer infuses new business and capital over time in the course of rehabilitating the business. A conversion will usually involve some contribution of money or property by the acquirer in return for the newly-issued stock, but the new owners may also contribute additional funds over time.

Supervisory conversions from mutual to stock form (as distinct from "standard" conversions of healthy mutuals) are authorized by Section 5(i) of the Home Owners' Loan Act of 1933 (12 U.S.C § 1464(i)) and Section 402(j) of the National Housing Act (12 U.S.C. 1725(j)). These conversions are called "supervisory" because they occur only when, for a federally-chartered mutual FSLIC-insured association, the Board could appoint a receiver for the association and, if liquidated, there would be no equity left for the association's members. Section 5(p) of the Home Owners' Loan Act, added by Section 121 of the Garn-St Germain Depository Institutions Act of 1982, also explicitly authorizes the Board to approve conversions on broader grounds that "severe financial conditions exist which threaten the stability of the institution" and "the conversion is likely to improve the financial condition of the institution." The Bank Board has issued regulations interpreting its authority for supervisory conversions under the above statutory criteria. See 12 C.F.R. Part 563b, Subparts C and D.7/

Although a merger of an institution in default or in danger of default may qualify as a type (G) reorganization under existing tax rules, the tax

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7/ Under the Board's regulations, the term "modified conversion" is generally used to include conversion of a mutual association which does not currently have the minimum required regulatory net worth but is not currently insolvent, and whose current and projected income is not sufficient to restore and maintain such net worth. A mutual association in this condition may convert to stock form under a Board determination inter alia that "severe financial difficulties exist which threaten the stability of the insured institution. * * *" 12 C.F.R. § 563b.36(a) and (c).

treatment of supervisory conversions is not completely clear. The only binding precedent, Rev. Rul. 80-105, 1980-1 C.B. 78, involves a fully solvent association which created "liquidation accounts" for its depositors. This account was considered to satisfy the tax requirement for a continuity of interest by owners of the "old" mutual. Rev. Rul 80-105 held that the conversion under these circumstances qualified as a type (F) reorganization.

If the converting institution is insolvent, however, and liquidation accounts are not established,[8] the rationale and authority of Rev. Rul. 80-105 seem to be inapplicable. Since the institution's assets are not physically transferred, the conversion is also not literally a type (G) reorganization. Therefore, the conversion of an insolvent institution may not qualify as taxfree at all.

Even if a mutual association's assets are transferred to a new or existing stock entity via a "merger conversion," the merger cannot qualify as a type (A) reorganization if the association is insolvent, and it cannot qualify as a type (G) reorganizations if the mutual is in financial distress but not yet to the point where a Board certification can be made under 12 U.S.C. § 1464(d)(6)(A)(i),(ii) or (iii).

The survival of net operating loss carryovers of the mutual association after a supervisory conversion is also unclear in several respects. If no liquidation account is established because the converting association is insolvent, and the conversion thus cannot qualify as a type (F) reorganization via Rev. Rul. 80-105, _supra_, the tax attributes of the mutual association will presumably be entirely eliminated. If the association is insolvent and a merger conversion format is used, so that the conversion may qualify as a type (G) reorganization, the survival of NOL carryovers will be determined by reference to deposit accounts in the converted association (see further discussion, _infra_). However, if the financial condition has not reached the level where a Board certification under the (G) rules can be made, several private letter rulings issued by the Internal Revenue Service have held that NOL carryovers are eliminated on the theory that liquidation accounts do not constitute "stock" for purposes of applying the tests under IRC section 382.

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[8] Liquidation accounts are not established in a supervisory conversion if the converting mutual association is insolvent or otherwise in default. See 12 C.F.R. § 563b.21.

These tax uncertainties handicap our efforts to use the supervisory conversion format to rescue ailing thrifts. We strongly urge that:

(1) the special definition of a type (G) reorganization for supervisory thrift mergers be updated to include supervisory conversions, regardless of the mechanical steps followed in the conversion process, and

(2) the corresponding exception in Code section 382 from restrictions on NOL carryovers be amended to include supervisory conversions.[9]

NET OPERATING LOSS CARRYOVER LIMITATIONS

The general rule of section 382(b) of the existing tax code provides that net operating loss carryovers of an acquired corporation will survive in full if the shareholders of the loss company receive stock worth at least 20% of the fair market value of the acquiring company after the merger. If the 20% minimum stock value is not attained, NOL carryovers are reduced by 5% for each one percentage point of stock continuity less than 20%.

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[9] Specifically, the definition of a qualifying thrift-type (G) reorganization in I.R.C. § 368(a)(3)(D) should be amended by including a "supervisory conversion" within the formats that will be treated as a type (G) reorganization.

For supervisory thrift mergers, section 382(b)(7)(B) allows this continuity test to be satisfied by comparing the dollar amount of deposits in the transferor association with total deposits of both associations after the merger. If the acquired deposits comprise at least 20% of total combined deposits, NOL carryovers survive the merger in full.

Section 382(b)(7)(B) is valuable chiefly where an acquiring stock institution acquires mortgages and customer deposits of a weakened association and substitutes equivalent deposit accounts in the acquiring institution, but without issuing any stock to the depositors. (Shareholders, if any, of the insolvent institution usually receive no stock from the acquirer.)

Section 321 of H.R. 3838 would revamp the entire set of NOL carryover limitations under IRC section 382 and, among other things, replace the 20% continuity test for mergers with a radically different concept. The 20% test and the concept of reducing the dollar amount of loss carryovers by reference to that percentage test would be eliminated in toto. The House bill would instead allow the entire carryover to survive in theory, but limit its use each year after the merger to a dollar amount equal to an annual deemed investment return per year on the "value" of the loss business as of the date of merger.[10]

These proposed new limitations would be extended to conversion transactions (apparently of any kind) where a mutual savings and loan association converts to stock form.[11]

The proposed new concepts appear to have been developed for mergers of healthy and fully solvent companies. They are difficult to apply fairly to an acquired company which is insolvent or in borderline financial condition. The comparison of deposits required by Section 382(b)(7)(B) also does not fit within a value test. For an insolvent thrift, a value test could effectively eliminate its carryovers after the merger, even if the business is rehabilitated.

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[10] H.R. 3838 would limit the use of carryovers, in any year, after a more than 50% change in the stock ownership of a corporation, to the product of the average yield for long-term tax-exempt bonds times the value of the loss company's equity immediately before the merger.

[11] See H. Rept. 99-426, 99th Cong., 1st Sess. 250, 264 (1985).

If the existing 20% continuity test of section 382(b) is replaced by an annual-return-on-value test, we believe that supervisory thrift mergers and conversions should be excepted from the proposed revision of Code section 382.

An exception of this kind will permit the Board to carry out its statutory responsibility to oversee financial institutions and protect their depositors by arranging, when necessary, a supervisory merger or conversion of the defaulted institution.

A federal savings and loan association can only merge directly with another federal savings and loan association or a FSLIC-insured institution. Net operating losses incurred before the merger by a thrift association can only be used after the merger against income of the acquiring financial institution. In our experience over five years, the special FSLIC tax provisions have worked well and have not been abused. We at the Bank Board have followed the tax requirements conscientiously. We have applied our certification authority responsibly.

It is also important to point out that FSLIC financial assistance agreements are structured so that in many cases FSLIC, rather than the acquirer, obtains the benefit of tax savings produced by NOL carryovers from the merged institution. FSLIC obtains this benefit by means of specific provisions contained in the assistance agreement which require part, or in some cases all, of the tax savings obtained by the acquiring corporation to be applied to reduce the cost of further financial assistance which FSLIC is obligated to provide with respect to the failing institution.

Proposed restrictions on built-in losses. Section 321 of H.R. 3838 introduces a new limitation on unrealized, or "built-in," losses of a corporation acquired in a merger. This proposed limitation would come into play even if a supervisory merger continues to receive taxfree treatment.

In the case of a thrift, built-in losses will include the accrued, "paper" losses reflected in the portfolio of low-interest mortgages which are currently worth less than the original loan amounts. The difference would be considered a "built-in loss" for tax purposes. The acquirer's sale of these old mortgages at any time during 10 years following the merger will cause the tax deductibility of losses from such sales to be limited as if they were losses incurred before the merger.[12]

This limitation will be harmful to precisely the sort of portfolio rebalancing which the industry needs. Old mortgages are the very assets which thrift institutions are attempting to dispose of in order to improve the quality of their investment assets and to upgrade their mortgages to more current interest-yielding levels. (In addition, limited deductibility of losses incurred when the old mortgages are sold off can be expected to produce requests from potential acquirers for indemnification by FSLIC of the extra tax burden resulting from the loss of deductions).

It is true that interest rates have moderated recently, and this has reduced somewhat the size of "built-in losses" on old mortgages. But the financial industry is precariously vulnerable to changes in interest rates. A swing upward in rate will increase the size of built-in losses on older, non-adjustable rate mortgages and intensify the harmful effects of the proposed restrictions. We encourage the upgrading of mortgage loan portfolios as a vital step to restoring the thrift industry to health and helping it adjust to today's interest rates and competitive environment.

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[12] Technically, the proposed restrictions on unrealized losses will come into play only if, at the date of merger, the acquired association has a net overall unrealized loss on all of its assets in the aggregate. The majority of FSLIC problem cases involve institutions which have such net unrealized built-in losses. Thus, most acquired institutions in supervisory cases will be subject to the proposed restrictions on unrealized losses.

This goal can be achieved if we allow post-merger restructuring to occur under normal tax deduction rules, and eliminate unusual restrictions based on pre-merger declines in value. We believe that any revision of Code section 382 should not apply to built-in losses on assets held by savings and loan associations.

CONCLUSION

Despite recent moderation in interest rates and because of severe asset quality problem cases, the challenge to the adequacy of the FSLIC fund has never been greater. We are facing the enormous challenge of finding solutions to our many supervisory cases. This is true even without taking the tax provisions of H.R. 3838 into account.

We cannot afford at this time to create new and unnecessary obstacles to these efforts from the tax side -- especially since the FSLIC provisions are part of existing law and have worked well without abuse.

In our view, repeal of the 1981 reforms for thrifts will cripple FSLIC's ability to resolve the large problems still facing the industry and will eliminate significant benefits to the public resulting from FSLIC's protection of insured and uninsured depositors. Supervisory mergers and conversions are crucial to the health of the financial services industry and to the continued confidence of depositors in the entire banking system. This confidence benefits the entire national economy.

We, or any member of our staff, would be happy to meet with you or your staff to discuss our concerns further.

Sincerely,

Mary A. Grigsby

Edwin J. Gray
Chairman

Donald I. Hovde
Board Member

Mary A. Grigsby
Board Member

/Attachment

ATTACHMENT

Legislative History of FSLIC Tax Provisions

The FSLC tax provisions were enacted by the Economic Recovery Tax Act of 1981. Senator Rudy Boschwitz's statement on the Senate floor, introducing the amendments relating to FSLIC-supervised mergers, sets forth the Congressional intent at that time as follows:

> "This amendment would facilitate the infusion of capital to a failing savings and loan or the merger of a savings and loan with another financial institution by clarifying that these transactions are nontaxable events.
>
> "The other alternative to capital infusions or mergers in the case of a troubled savings and loan would be liquidation by the Federal Savings and Loan Insurance Corporation. This would require payment out of their insurance funds to all insured depositors and would have unfortunate results for non-insured depositors. The potential cost to the Government, depositors, and shareholders could be significant. This amendment will help the Federal Home Loan Bank Board avoid these consequences.
>
> "Under current law, there is some uncertainty about the tax consequences of capital infusions to savings and loans or mergers of savings and loans. This uncertainty deters potential investors and will likely result in the more costly liquidation payouts by the FSLIC.

"Deeming a merger or capital infusion to be a taxable event will deny possible benefits to a financial institution taking over a troubled savings and loan and would trigger additional tax liability of a savings and loan which received additional capital.

"For example, if new capital is provided it may be considered a contribution to capital by a nonshareholder, which would require the savings and loan association to reduce its tax basis on certain assets under section 362(c) of the Internal Revenue Code.

"Also, the repayment of this capital might be considered a redemption of capital stock from the association's bad debt reserve, which would trigger payment of ordinary income tax. This amendment would assure that these transactions are tax-exempt and thus allow the FSLIC to loan capital to weakened savings and loans until they are back on their feet. If not, we could end up with a Government bail-out of depositors, a result that could ultimately prove very costly.

"The need for this amendment is immediate. The Federal Home Loan Bank Board currently has 404 institutions on their troubled list. Through June of this year [1981] we have already seen as many mergers as took place in all of 1980. This year there has also been the first liquidation of a savings and loan since 1971.

"Surely an infusion of capital to a troubled institution to allow it to become viable again is a far better solution than letting it go under. And surely a merger of a failing savings and loan serves the public interest better than liquidation."[13]

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[13] Cong. Record, July 23, 1981, p. S-8288.

February 7, 1986

FSLIC Positions On Tax Bill, H.R. 3838

It is crucial to the Federal Savings and Loan Insurance Corporation, and to public confidence in the nation's financial institutions, that any tax reform retain the existing tax provisions which facilitate supervisory mergers and conversions of failing thrift institutions. These tax provisions of the Internal Revenue Code are:

> Section 368(a)(3)(D)(ii) (taxfree reorganization treatment of supervisory thrift mergers);
>
> Section 382(b)(7)(B) (net operating loss carryovers in taxfree supervisory mergers);
>
> Section 597 (FSLIC assistance not taxable); and
>
> Section 593(e)(1) (last sentence) (no recapture of bad debt reserve when FSLIC assistance is repaid).

Section 804 of H.R. 3838 would repeal all of these provisions effective on January 1, 1986. This action will have a devastating effect on the Federal Home Loan Bank Board's ability to arrange supervisory mergers and will lead to enormous strains on the FSLIC insurance fund. It will practically eliminate potential acquirers willing to work with the Board on supervisory transactions. The result will be a drastic increase in the cost of resolution of defaulted institutions. This will in turn place the insurance fund under more critical stress than it already faces. In the Board's opinion as regulators, H.R. 3838 will devastate the weak elements of the thrift industry and further jeopardize the basic solvency of the insurance fund.

Revenue increases estimated by the House tax staff from repealing the FSLIC tax rules -- $1.3 billion over 1986-1990 -- are completely illusory. If mergers and FSLIC assistance can no longer occur taxfree, acquisitions will practically cease to occur. Tax revenues will then not arise at all. In fact, liquidating payments will increase and, since the full faith and credit of the U.S. backs the insurance fund, ultimately cost the Treasury more than the cost of continuing the existing tax rules.

In some pending negotiations, potential acquirers are already asking FSLIC to indemnify them for the increased tax liabilities that will arise if the merger and FSLIC assistance are taxable. If FSLIC were to agree to increase its assistance, the drain on the insurance fund will be accelerated. The transaction might become legally impossible, because the cost of assistance could exceed the cost of liquidation.

No tax abuses occur under the FSLIC tax rules. Only savings and loan associations can use another association's tax attributes. FSLIC assistance agreements also require that tax benefits realized by an acquiring association benefit FSLIC by reducing future assistance obligations.

The Board urges the following:

1. The FSLIC tax provisions should be continued in effect and not repealed. Section 804(a) and (b) of H.R. 3838, which repeal the FSLIC provisions, should be rejected. As to net operating loss carryovers, see 2. below.

2. Supervisory thrift mergers and conversions should be excepted from the proposed new revision of restrictions on net operating loss carryovers (and on so-called "built-in" losses) under section 382 of the Internal Revenue Code. (Section 321, H.R. 3838.)

3. IRC section 265(1) should not apply to thrifts which receive FSLIC assistance.* Section 804(c)(2)(B) of the House bill contains such a clarification, but only for 1981 through 1985. This provision of the House bill is sound, and should apply for the entire period during which the FSLIC tax rules are continued.

4. The taxfree reorganization category should be amended to cover supervisory conversions (as well as mergers) of troubled thrifts.

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* This Code section disallows deductions for expenses "allocable to" receipt of tax-exempt income.

TESTIMONY OF MICHAEL B. HERNANDEZ
BEFORE THE U.S. SENATE COMMITTEE
ON BANKING, HOUSING & URBAN AFFAIRS

The lack of attention to date to the fate of municipal bonds under the proposed Tax Reform Act of 1985 would lead one to believe that the municipal bond market is an insignificant component of the national economy. Nothing could be further from the truth. In 1984, $99 billion in municipal securities were issued, and the $100 billion milestone was left far behind in 1985. The amount of state and local government obligations issued and traded on an annual basis is as high as the corresponding figures for the stock and corporate bond markets. The importance of the public purpose projects financed through such tax-exempt municipal securities cannot be overstated.

The First Boston Corporation, on behalf of which I submit this testimony, is deeply concerned about the potential impact of new legislation on this vital and beneficial sector of the economy, and is therefore gratified that this Committee has undertaken to investigate the subject. The possibility that the tax bill passed by the House of Representatives will be enacted in its current form already has had the disquieting effect of bringing the market for new municipal obligations to a virtual standstill. Unless the Senate revises or eliminates the restrictions on tax-exempt financing contained in H.R.

3838, what is now a temporary lull may become a permanent downturn with highly disruptive consequences for state and local governments and for the economy as a whole.

States and localities traditionally have used tax-exempt borrowing to finance basic societal needs: schools, roads, water and sewage systems, public power facilities, hospitals, and low-income housing, to list but a few examples. Investors in municipal securities accept a lower rate of return on such government obligations in exchange for the guarantee that their income from such investments will not be reduced further by federal taxation. For investors in the top tax brackets, the yield on municipal securities may be somewhat higher than the after-tax yield available to them on taxable securities. The prime beneficiaries of tax-exempt instruments are not the investors, however, but state and local entities which obtain credit at an approximately one-third discount, and the general public, to whom government facilities or services are made available at affordable rates.

H.R. 3838 mounts a two-pronged attacked on this bastion of state and local financing. First, the bill narrows the types of public purpose projects that may benefit from tax-exempt financing, and places stringent volume limitations on a multitude of previously unrestricted state and local borrowings. Second, the bill conditions the tax-free status of municipal obligations on compliance with a variety of new restrictions on the investment and expenditure of bond proceeds, and subjects income on certain municipal securities to alternative taxes, thereby eroding investor confidence that such obligations are or will remain tax-free, and increasing the cost to issuers of attracting bondholders.

As a practical matter, the radical changes in the tax treatment of municipal obligations under H.R. 3838 would divide state and local financing into two categories: the unfeasible, and the more expensive.

H.R. 3838 ELIMINATES BROAD CATEGORIES OF TRADITIONAL PUBLIC PURPOSE FINANCING

In order to raise an estimated $3.8 billion in additional federal revenue over the next five years, the tax bill makes tax-exempt financing inaccessible for valuable and necessary public projects. The bill provides that interest on any "non-essential function" bond which is not a "qualified bond" shall be taxable. The concept of non-essential function bonds is a new one and significantly restricts the permissible level of private participation in the creation and management of facilities and services used by the general public.

The "Non-Essential Function" Bond

Under current law, municipal obligations generally are tax-exempt unless more than 25% of the bond proceeds are used in the trade or business of a non-exempt entity and more than 25% of the principal or interest due on the borrowing is to be repaid from revenues of such trade or business. The bill alters the law by treating as disfavored "non-essential function" bonds any state or local borrowing 5% or $5 million of which is loaned to a non-governmental entity, or 10% or $10 million of which is "used" by a non-governmental entity. The reduction of the "trade or business" test threshold from 25% to 10%, the elimination of the "security interest" test, and the expansion of non-exempt users to include non-profit organizations dramatically reduces eligibility for tax-exempt financing. Under this new "10% rule," contracts for the management of small portions of public facilities by private entities could result in the loss of tax-exempt status. Projects such as public power facilities, hospitals and sewer facilities, which by their nature require a high level of private participation, in many instances no longer could be financed on a tax-exempt basis, and therefore would become prohibitively expensive.

Other projects subsumed in the new category of "non-essential function" bonds would be multi-family housing, solid waste and resource recovery facilities, mass commuting facilities, water supply systems, airports, student loans and educational facilities. Such projects would have to compete with each other, as well as with portions of general obligation financings attributable to non-governmental use, for an allocation under a new rationing system for tax-exempt financing established by H.R. 3838.

The Volume Cap

Current law establishes separate volume limitations for mortgage subsidy bonds and for industrial development and student loan bonds. No restriction is placed, however, on the volume of bonds issued to finance facilities for non-profit entities such as hospitals and colleges. H.R. 3838 would impose a unified volume cap for all "non-essential function" bonds to be applied on a calendar year and state-by-state basis. The proposed volume limitation is the greater of $175 per resident or $200 million per state until 1987, thereafter dropping to the greater of $125 per resident or $200 million.

The First Boston Corporation believes that the volume cap on "non-essential function" is inadequate and should be eliminated. A volume cap may be appropriate for small issue industrial development bonds, which always have been controversial because they primarily benefit private corporations. There is no place in today's economy, however, for such an artificial limitation on the use of tax-exempt financing for non-profit hospitals, educational institutions, housing, and other projects obviously in the public interest. Under the proposed cap, up to 40% of revenue bond financings for such building blocks of our society as housing and education would be eliminated. Such a reduction could not be more ill-conceived at a time when federal contributions for these basic needs, in the form of UDAG grants, revenue-sharing, and the guaranteed student loan program, are being reduced dramatically or phased out as part of the battle against the federal deficit.

H.R. 3838 MAKES ALL TAX-EXEMPT FINANCING MORE COSTLY

The tax-exempt status of municipal obligations at times has been characterized as a federal subsidy to state and local governments. Critics argue that this "subsidy" is an inefficient one, in that the cost to the federal Treasury in lost revenues is greater than the benefit reaped by states and localities in the form of lower borrowing costs. Because the historic treatment of municipal obligations is firmly rooted in the constitutional doctrine of reciprocal tax-exemption by the state and federal governments for each other's credit instrumentalities, the "subsidy" argument rings hollow. But even if tax-exempt borrowing by states and localities is considered a matter of federal largesse rather than constitutional right, it would be gratuitously destructive to revise the tax code in a manner that decreases the efficiency of this "subsidy". Regretably, H.R. 3838 does precisely that by imposing numerous restrictions that will increase the cost of all state and local borrowing without any corresponding gain by the federal Treasury.

Arbitrage Rules

The primary purpose of arbitrage rules is to prevent abuses of tax-exempt borrowing privileges and to ensure that bond proceeds are applied to the projects for which they are targeted. The rules are designed to restrict borrowers from obtaining tax-exempt loans for the purpose of profiting by delaying the expenditure of bond proceeds and investing such proceeds at a higher rate of return than that being paid to the bondholders. States and localities, however, have been permitted to derive and make use of limited arbitrage profits over the life of the bond, and unrestricted profits during certain "temporary periods" and on the investment of a "minor portion" (15%) of the proceeds. Users of industrial revenue bonds, by contrast, have been required, with limited exceptions, to rebate arbitrage profits to the federal government. H.R. 3838 takes the unprecedented step of extending the coverage of the rebate rules, and other arbitrage rules, to all tax-exempt financings, including essential function bonds. The result is that the difficulty and expense of issuing traditional general obligation bonds and revenue bonds will increase, and such instruments will become less attractive to investors.

The bill requires all issuers to calculate on an annual basis their arbitrage profits, as well as the earnings on those profits, and rebate such profits and earnings to the United States Treasury every five years. Exceptions to this requirement are provided in limited instances when all gross proceeds are spent within six months of issuance or, with respect to earnings on debt service funds, if such earnings are less than $100,000 per year. Thus, the bill confiscates for the federal Treasury all profits derived by states and localities on their borrowings, and thereby will force such issuers to issue an increased amount of bonds to finance projects and services than they would under current law. In addition, provisions in the bill impose the risk of retroactive loss of tax-exemption on every bond issued after January 1, 1986 upon any non-compliance with the rebate rules. This threat means that a risk premium will have to be paid to investors, driving up the costs of all state and bonds without benefitting the federal government. Moreover, government issuers would sustain the additional administrative expense of accounting for and rebating their arbitrage profits.

Although the rebate requirement makes the United States Government the sole beneficiary of arbitrage profits, the bill in addition imposes severe new limitations on the yield at which bond proceeds may be invested. Under H.R. 3838, the general three-year temporary period rule currently in effect is replaced with new temporary periods for construction and acquisition projects. Proceeds used for construction, for example, would have to be yield-restricted to prevent positive arbitrage on the earliest of (a) the date when the project is 90% complete or is abandoned, (b) the date when an amount equal to all bond proceeds has been expended on the project, (c) three years from the beginning of construction, or (d) three years from the date the bonds are issued. The bill's legislative history indicates that whenever a project is delayed for a substantial period, it is deemed 90% complete. Thus, a strike or other delays beyond the issuer's control may terminate the temporary period, cause non-compliance with the yield-restriction requirement, and result in loss of tax-exemption retroactive to the date of issuance.

The bill also imposes new "early issuance" rules that render bonds taxable unless at least five percent of the net proceeds are spent within 30 days of issuance, and 100% of the net proceeds are spent within three years. This rule is essentially unworkable for issuers in states with laws requiring that all financing be in place before construction contracts are bid, and may preclude long term construction projects. Moreover, these rules raise the possibility that cost underruns will result in the loss of tax-exemption.

All these requirements meddle extensively in the fiscal independence of state and local governments. None of these provisions limit the amount of tax-exempt bonds issued, or promote tax simplicity, and, except for the rebate requirement, none of the provisions increase Federal revenues. Even the rebate requirement would result in minimal revenue enhancement to the United States at the expense of great administrative inconvenience to states and localities.

The new rebate and yield-restriction rules serve no purpose when applied to states, cities, towns or non-profit users. Even if there were some policy justification for depriving states and localities of all earnings on their borrowings, subjecting government entities to both the rebate and yield-restriction rules is senseless. We would urge that these restrictions be limited to corporate users of tax-exempt borrowings, who are equipped to perform the monitoring and accounting functions required by such rules. The threat of retroactive taxation should be removed so that the certainty of tax-exemption which is the bread and butter of the municipal bond market can be restored. At a minimum, the penalty of retroactive taxation should be confined to intentional violations of the arbitrage and early issuance rules.

Alternative Taxes

Unlike many of the arbitrage restrictions, the alternative taxes proposed in H.R. 3838 are designed to provide some incremental revenue to the federal Treasury to help finance reductions in the tax rates payable by federal taxpayers. These taxes, however, are ineffectual and, along with other provisions in the bill, will reduce the effectiveness of tax-exempt financing. For example, the bill treats "non-essential function" bonds as preference items for purposes of computing an alternative minimum tax. The foreseeable result is that investor confidence in the yield of such bonds will be undermined. Investors potentially subject to the tax will avoid it by investing in "essential function" bonds, thereby decreasing demand for "non-essential function" bonds and increasing the cost of financing hospitals, student loans, low-income housing, and the like.

The bill also decreases the marketability of tax-exempt bonds to banks and property/casualty insurance companies, which constitute a large share of the current market. The bill, with certain exceptions, would disallow interest expenses incurred by financial institutions for the acquisition of tax-exempt obligations purchased after December 31, 1985. In addition, loss deductions by property and casualty insurance companies would be reduced by a proportion of the amount of tax-exempt interest received on bonds acquired after November 15, 1985 and, beginning in 1988, such bonds also would be subject to an alternate income tax imposed on such insurance companies. These provisions would force issuers to raise interest rates on all bonds to continue to attract these traditional investors.

Such alternative tax provisions are based on the premise that "everyone should pay some tax." However, they fail to take into account that holders of tax-exempt municipal obligations already pay a tax in the form of a reduced return on their investments. The market for state and local obligations should not be disrupted merely because the beneficiaries of this "tax" are state and local entities rather than the federal Treasury.

ADVANCE REFUNDINGS

The bill would prohibit the advance refunding of all non-essential function bonds, and defines advance refunding as the issuance of refunding bonds more than 30 days prior to retirement of the refunded issue. In many instances, this would prevent any type of refunding since indentures often require 30 days notice of a refunding. State and local issuers would thereby forfeit the cost savings associated with refinancing their borrowings after a favorable drop in interest rates.

CONCLUSION

H.R. 3838 if enacted in its present form would severely impair the functioning of a multi-billion dollar market serving the needs of citizens. The economic and social costs of the proposed restrictions far exceed the approximately one billion dollars per year that would be added to the federal Treasury and passed on to federal taxpayers in the form of tax relief. The state and local governments, which have only begun to cope with the combined effect of federal budget cuts and previous restrictive amendments to the tax code, should not be subjected to this latest and most severe challenge to their self-sufficiency.

First Interstate Bank

First Interstate Bank
of Nevada, N.A.
President's Department
One East First Street
Reno, NV 89501
702 784-3345

Gary W. Fiedler
President and
Chief Executive Officer

February 3, 1986

The Honorable Chic Hecht
United States Senator
Room 304, Hart Senate Office Bldg.
Washington, D.C. 20510

Dear Senator Hecht:

The Senate Banking Committee has scheduled hearings for February 4, 5, and 6, 1986, to discuss the effect of tax reform proposals, particularly H.R. 3838, on the financial institutions industry. I thought it appropriate to inform you of my views on the same subject. My comments will focus on the particular provisions that we believe are detrimental to the banking industry and the overall economy.

There are two key provisions of H.R. 3838 that have a significant adverse effect on First Interstate, the banking industry in general, and the economy: the repeal of the reserve method of accounting for loan losses (and the related recapture of the existing reserve balance) and the draconian changes to the foreign tax rules. A general discussion of each of these points follows and more detailed memoranda are attached for your reference. It first should be pointed out, however, that commercial banks have long been a highly efficient financial intermediary between borrowers and lenders. The tax benefits associated with many financial intermediary transactions, particulary tax-exempt lending and various leasing transactions, have been largely passed on to borrowers and lessees through rate adjustments. Without the tax benefits, the rates would increase, thus, passing most of the loss of tax benefits to the end user.

Of even greater significance, I believe the two provisions would weaken the U.S. banking industry. This is of special concern because the strength of the U.S. economy depends on the soundness and efficiency of its financial system.

LOAN LOSS RESERVE

The use of the reserve method of accounting for loan loss reserves does not, contrary to the belief of some people, create a tax shelter for banks. To illustrate, as of December 31, 1984, the 22 banks in the First Interstate group had tax loan loss reserve balances totaling $232.2 million. The 1985 net charge-offs of these same banks totaled $290.9 million. The financial statement loan loss reserve for these same banks totaled $395.4 million. Thus, it is clear that the use of the reserve method does not create a tax shelter; in fact, the tax loan loss reserves are woefully understated as evidenced by the fact that 1985 net charge-offs exceeded the amount of the loan loss reserve as of the beginning of 1985.

The Federal Reserve is encouraging banks to raise their capital-asset ratios. At a time when the agricultural and energy industries are having severe difficulties and further loans to less developed countries are being encouraged by Treasury Secretary Baker and Federal Reserve Board Chairman Volcker, Congress should not be contemplating the repeal of the reserve method. Such repeal would require First Interstate to raise over $150 million of capital to maintain its existing capital-asset ratio.

Permitting banks a bad debt deduction only when a loan has become wholly or partially worthless and is charged off ignores economic reality. The economic loss associated with credit risks occurs much earlier than the time a loan is written-off for tax purposes. The charge-off is the last step in the evolution of a troubled loan.

Maintaining adequate reserves for loan losses is not only a fundamental and prudent practice for banks, it is essential to the safety and soundness of the banking industry and the protection of its depositors. We believe that the bill, S. 1263, introduced by Senators Roth and Boren, to require book-tax conformity for loan loss reserves would be appropriate to better measure the adequacy of both book and tax loan loss reserves.

FOREIGN TAX RULES

The foreign tax provisions of H.R. 3838 would place U.S. commercial banks at a substantial disadvantage in overseas credit markets. While some might argue that this forcing of U.S. banks to do more of their business in the U.S. would be beneficial, we believe the opposite effect would occur. Foreign loans made by U.S. banks are a significant factor in the financing of U.S. commodities, products, and services abroad. Accordingly, a reduction in the competitiveness of U.S. banks would have an adverse impact on U.S. trade, our balance of payments, and even on domestic employment. First Interstate's after-tax return on loans to finance U.S. exports to Mexico and Brazil would decrease by 76% and 84%, respectively. At a time when our trade deficit is soaring, Congress should not enact legislation to further compound the problem.

The foreign tax proposals single out - and discriminate against - U.S. commercial banks. Only banks are denied the full creditability of gross withholding taxes paid in lieu of income taxes. Also, the bill in effect states that foreign subsidiaries of U.S. banks are not engaged in the active conduct of a trade or business. Accordingly, banks would be taxed on most undistributed earnings of foreign subsidiaries, unlike other corporations.

H.R. 3838 is particularly harmful to existing loans to less developed countries. Such loans were structured assuming that the current U.S. tax rules would apply to permit the full credit for all taxes paid to foreign governments. Even with the proposed three-year transition rules, the House bill would retroactively change the economics of many of these loans. Compared to current law, First Interstate's after-tax return on assets on loans to Mexican borrowers and Brazilian borrowers would decrease by 20% and 30%, respectively.

Due to the fragile nature of the economics of Mexico, Brazil and other less developed countries, banks cannot increase the rates to ameliorate the loss of tax credits. Also, a cutback in future lending would be detrimental to the developing economies and counter to the Baker Plan.

I hope you will keep these thoughts in mind as tax reform, in whatever shape it may take, is considered by the Banking Committee and the full Senate. For additional information, two memoranda further discussing these issues are attached. Also, if you or a member of your staff would like to meet with or discuss specific tax issues, please feel free to call Tom Revell, the head of First Interstate Bancorp's tax department at (213) 614-7707.

Sincerely,

Gary W. Fiedler

attachments

/sc

H.R. 3838

FOREIGN TAX PROVISIONS

The foreign tax provisions contained in H.R. 3838 are numerous and represent major changes to current law. By the Ways and Means Committee's own admission, the provisions would add to the complexity of an already complex set of tax rules and compound the administrative burden associated with compliance. These provisions further single out the commercial banking industry for particularly harsh and discriminatory treatment.

This memorandum focuses on two sets of tax law changes contained in H.R. 3838 which, if enacted, will have the greatest detrimental impact on U.S. banks providing financial services abroad:

- The active, mainstream business income of banks, earned through foreign corporations, would be currently taxed instead of being taxed upon repatriation as is the case with other U.S.-owned foreign corporations.

- Foreign withholding taxes imposed on interest received by banks would not be creditable or deductible to the extent such withholding tax exceeds the U.S. tax on such interest income, reduced by the cost of funds and other allocable expenses.

While generally retaining long-standing principles of U.S. taxation of foreign income for U.S. companies, these provisions represent a departure from such principles in the case of banks. Because of the unfavorable tax treatment imposed directly on the principal business income of banks, these provisions would further restrict the ability of U.S. banks to be competitive in an already highly competitive international banking environment.

As elaborated below, this memorandum concludes that (i) the current banking exception from Subpart F income should be retained, and (ii) the existing tax rules which treat foreign withholding taxes on interest as fully creditable should not be changed.

Current Taxation of Banking Income Earned Through Foreign Subsidiaries

Under H.R. 3838, banks would be currently taxed on most undistributed earnings of foreign subsidiaries. This is achieved by expanding the types of income included in foreign base company income (including foreign personal holding company income) subject to current taxation under Subpart F of the Internal Revenue Code and by narrowing the exceptions to Subpart F income, in the following manner:

1. Foreign personal holding company income (FPHCI) generally would be expanded to include (i) gains from the sale or exchange of property which generate passive income, (ii) income from commodities transactions and (iii) foreign currency gains (except hedging).

2. The Bill would repeal the exclusion from FPHCI, for Subpart F purposes, of amounts received from unrelated persons in the active conduct of a banking, financing, or similar business.

3. The Bill would repeal the exclusion from FPHCI, for Subpart F purposes, of interest paid by a related person to a controlled foreign corporation, if both are engaged in a banking, financing or similar business.

4. An exception is provided for income subject to high foreign taxes, applied separately to each "item of income."

As a general rule, foreign corporations, including U.S.-owned foreign corporations, are not subject to U.S. taxation on earnings not effectively connected with a U.S. trade or business. U.S. shareholders of foreign corporations are taxed when the profits are distributed as a dividend, or when profits are "deemed" to be distributed.

In 1962, a tax policy decision was made to continue the deferral of U.S. taxation on active business income earned by a U.S. controlled foreign corporation (CFC) and to currently tax certain types of tax haven income under Subpart F. At that time, Congress deliberately and appropriately decided that passive-type income classified as FPHCI represented active and mainstream business income in the case of banks, and deferral of U.S. taxation of such income earned by banks was appropriate under the tax policy of deferring taxation on active income.

H.R. 3838 would eliminate the banking exception from FPHCI while expanding the definition of FPHCI to include other items of active income earned by banks. Thus, if enacted in its present form, banks would effectively be required to pay taxes on their worldwide income without regard to corporate identity or non-tax avoidance motives. U.S. companies other than banks would continue to defer U.S. taxation on the active business income of their foreign subsidiaries.

The Committee Report generally conclude that these changes are needed on the premises that (i) income from financial assets are susceptible to manipulation through movement to and from geographic locations in order to achieve deferral and/or low taxation, and (ii) such income could easily be earned through a U.S. corporation rather than a foreign corporation. Only if such income is earned in a high-tax foreign country could non-tax motives be respected and, thus, excepted from the new Subpart F rules of H.R. 3838.

Quite the contrary is true; banks have less opportunity than other U.S. industries to arbitrarily manipulate income. Recognition should be given to the fact that the primary factors in determining the geographic location offshore as well as the decision to form a subsidiary are (1) marketing and distribution, (2) regulatory and legal considerations, and (3) operational considerations. Tax factors are always secondary to these considerations.

The effect of subjecting active income to current taxation would severely restrict the ability of U.S. banks to be competitive with their foreign counterparts.

Creditability of Foreign Withholding Taxes

H.R. 3838 would limit the creditability of foreign withholding tax on interest income (or its equivalent) that is received by banks to the extent the tax exceeds the U.S. tax on that net interest income. Any portion disallowed under this limitation is permanently noncreditable (may not be carried back or forward) and is nondeductible. A three year transition period is provided in the case of existing loans to certain developing countries.

The application of the provision is illustrated in the Committee Report on H.R. 3838:

> Assume a U.S. lender makes a $1,000 loan to a foreign borrower at a 10-percent annual interest rate. The lender's annual cost associated with the loan (including cost of funds and other properly allocable costs) is 8 percent of principal. The annual net interest income associated with the loan is $20 ($100 of interest income less the $80 annual cost associated with the loan). This net interest income is subject to $7.20 of pre-foreign tax credit U.S. tax (36 percent of $20). The borrower's country of residence imposes a 15-percent gross withholding tax on the $100 annual interest payments, that is, $15 of tax per year. Under the Bill, this gross withholding tax is not creditable to the extent that it exceeds the $7.20 of U.S. tax attributable to the associated interest income. Therefore, $7.80 of the foreign tax ($15 less $7.20) is noncreditable and nondeductible.

The impact of this provision as compared to current law may be illustrated utilizing the facts in the example above provided by the Committee Report:

Under current law the full foreign withholding tax of $15 will be creditable subject to the overall (averaged) foreign tax credit limitation. As such, the after-tax income on the above transaction may be expressed as $20 less the U.S. tax rate, or $10.80 ($20 minus 46% x $20). Under H.R. 3838, as shown above, $7.80 is noncreditable and nondeductible. However, the entire $15 withholding tax is a cost attributable to the transaction. Therefore, the after-tax income under the Bill is $5 ($20 minus $15) representing a 53.7% reduction in after-tax income.

The noncreditable portion of the foreign withholding taxes would also be nondeductible. Thus, banks would effectively be required to treat as taxable the component of interest represented by the full amount of withholding taxes while being denied a deduction, as well as a credit, for costs incurred to generate the related income.

The United States' tax laws generally seek to avoid double taxation by allowing a credit against U.S. income taxes for taxes paid to foreign jurisdictions. In general, the credit is allowed only for "income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States." However, the Code also explicitly permits a credit for taxes paid "in lieu of" these types of taxes. As a general rule foreign withholding taxes on interest are treated as creditable taxes "in lieu of" an income tax under current law.

The Committee Report indicates that the problem at which the change contained in H.R. 3838 is aimed is the averaging for foreign tax credit purposes, under the overall foreign tax credit limitation, of high gross withholding taxes with low taxes or no taxes paid on certain income earned abroad. All U.S. taxpayers can avail themselves of the perceived benefits of "averaging" under current law, yet H.R. 3838 would preclude full inclusion of gross withholding taxes on business interest for foreign tax credit limitation purposes; this provision principally affects banks.

According to the Committee Report, banks have been singled out on the premise that the economic burden of the withholding tax on interest typically falls on the foreign borrower rather than on the U.S. lender. Such a premise is totally invalid. Banks bear the economic burden of withholding taxes either by direct payment or by reduced interest income. Moreover, even if the transaction were structured so that there could be no doubt that the bank bore the economic costs of a transaction (which would be the case, for example, where the bank was not entitled to a gross up for withholding taxes), this provision would still limit creditability.

Banks would be subject to double taxation on interest income under the limitation proposed by H.R. 3838, the precise result that the foreign tax credit rules were designed to prevent. It is naive to assume that a bank is somehow relieved of any economic liability for a tax when liability for it is formally assumed by the borrower. In such a situation banks would simply be unable to demand as high an interest rate, and would just as clearly bear the cost of such tax as if they had paid it themselves. The unavailability of the credit would, therefore, give rise to double taxation on this income. The denial of a deduction for the noncreditable tax makes the singling out of banks even more discriminatory. While denying the substance of withholding taxes as an economic cost to banks, H.R. 3838 would include this amount as taxable income through disallowance of the deduction.

The limitation on the creditability of foreign withholding taxes will have a significant adverse economic impact on the foreign lending activities of U.S. banks, especially with respect to loans to developing countries with high withholding taxes. At a time when U.S. banks are being requested to make even greater commitments to these countries, such discriminatory and harsh treatment is particularly inappropriate.

* * * * * * * * * * *

The foreign tax provisions of H.R. 3838 are far reaching and would, if enacted, significantly add to the complexity of current law. On the whole, the provisions are detrimental to U.S. taxpayers conducting business abroad. Within these generally detrimental provisions, banks have been singled out on a highly discriminatory basis. Long standing principles regarding U.S. taxation of income derived abroad have been retained for all U.S. taxpayers, except for banks. Banks alone would be taxed on active business income earned through foreign subsidiaries. Banks would be denied a credit or deduction for a portion of any foreign withholding taxes on their principal business income earned abroad, while the general creditability and/or deductibility of these taxes would continue to be allowed for other U.S. businesses.

The United States has recently become a net debtor country for the first time since 1914. The considerable legal and practical disincentives for banks to conduct business activity abroad do nothing to correct this imbalance. The United States government is currently seeking to redress these problems by obtaining some trade protection for the financial services industries. H.R. 3838 would only exacerbate the situation by imposing double taxation and an excessive tax burden on a significant portion of income derived from overseas banking activities. To a large extent the major foreign banks in the U.S. are permitted tax credits by their home country under foreign tax credit provisions which are generally more favorable than that provided by the U.S. under current law. Curiously, H.R. 3838 serves to benefit foreign banks in the U.S. through reduced corporate tax rates, while adversely impacting U.S. banks doing business abroad.

If these two provisions are enacted, the detrimental impact on U.S. banks conducting business abroad will be significant. U.S. competitiveness will be severely diminished for banks financing U.S. commodities, products and services abroad. Consideration of the resulting impact on U.S. trade and the current balance of payments deficit cannot be avoided or ignored.

H.R. 3838

LOAN LOSS PROVISIONS

If enacted in its present form, H.R. 3838 would make the following changes to existing law regarding loan losses of commercial banks:

1. Large banks (defined as a bank or parent-subsidiary controlled group with average assets exceeding $500 million) would be precluded from using the reserve method of accounting for bad debts.

2. Future bad debt deductions of large banks would be limited to net charge-offs.

3. Large banks could elect to either (i) recapture their existing loan loss reserves ratably over a 5-year period or (ii) charge future loan losses against their existing loan loss reserves until such reserves are exhausted and to deduct only the excess.

4. Small banks would continue to follow existing law regarding loan losses.

As discussed more fully below, this memorandum concludes that (i) the reserve method of accounting for loan losses should be retained and (ii) the reserve should be based on generally accepted accounting principles (GAAP) and regulatory standards. The discussion focuses on large banks as they would bear the burden of the loan loss reserve provisions of H.R. 3838.

Need for Loan Loss Reserves

The loan loss reserve provisions available to commercial banks under current law have been criticized as a means for banks to reduce their tax liability. Such criticism may have been valid 20 years ago and, in fact, Congress greatly limited the bad debt deductions that banks could claim in the Tax Reform Act of 1969. Current law now permits banks to use a six-year moving average or a percentage of eligible loans method of computing their bad debt deduction. As a practical matter banks have not used the percentage method since 1982 and its use will be precluded completely after 1987.

For the past few years, the financial statement loan loss reserves of most banks have exceeded the tax loan loss reserves. A review of the 1984 annual reports of some of the major banking organizations indicates that many banks pay greater amounts of income taxes currently because their financial statement loan loss deduction is greater than their tax loan loss deduction. Shown below is a list of some major banking organizations and the additional taxes paid because of the limitations on their tax bad debt deduction (data based on 1984 annual reports):

	AMOUNT (in 000s)	
CORPORATION	**1984**	**1983**
BankAmerica Corporation	$ 9,000.	$20,000.
Texas Commerce Bancshares, Inc.	10,000.	4,000.
Wells Fargo & Company	20,547.	2,193.
Marine Midland Banks, Inc.	29,465.	11,086.
First Interstate Bancorp	3,540.	7,140.
Crocker National Corporation	24,037.	44,569.
Security Pacific Corporation	38,464.	(7,295.)
Rainier Bancorporation	4,160.	2,718.
RepublicBank Corporation	16,453.	19,054.
J.P. Morgan & Co., Incorporated	47,100.	62,300.

Current law unduly restricts the computation of the proper amount of a bank's loan loss reserve addition (i.e., bad debt deduction). The repeal of the reserve method of accounting for loan losses would only exacerbate the problem.

Within the past five years, many industries have experienced a great deal of economic uncertainty and financial difficulty. These include agriculture, mining, timber, construction, oil and gas, and various manufacturers.

Commercial banks have been the principal lenders to each of these industries. Many businesses have failed and many more are continuing to experience financial difficulty.

The elimination of the loan loss reserve for commercial banks would be akin to requiring capital intensive industries to claim a depreciation deduction only in the year the related asset is abandoned. Just as an asset depreciates over time, a loan portfolio becomes partially worthless over time. Both the reserve for accumulated depreciation and the reserve for loan losses are essential to measure the loss in value inherent in the related assets at a point in time. It is recognized that the Congress has long provided an "incentive" depreciation system; no comparable incentive is sought with respect to loan losses of commercial banks.

Measurement of Loan Loss Reserves

A properly determined loan loss reserve represents the economic loss inherent in a bank's loan portfolio. Current tax law essentially forces banks to compute their bad debt deduction using the six-year moving average method. Accordingly, a bank has to compute its current bad debt deduction based in large part on its experience of more than three years earlier. Entire economic cycles can, and often do, occur within a three-year period.

For financial statement purposes and bank regulatory accounting purposes, commercial banks are required to compute the loan loss reserve in accordance with generally accepted accounting principles (GAAP). What constitutes GAAP for this purpose is set forth in the industry audit guide issued by the American Institute of Certified Public Accountants entitled Audits of Banks (hereinafter referred to as "Bank Audit Guide").

The Bank Audit Guide states (at page 61):

> A bank should maintain a reasonable allowance for loan losses applicable to all categories of loans through periodic charges to operating expenses. The amount of the provision can be considered reasonable when the allowance for loan losses, includ-

> ing the current provision, is considered by management to be adequate to cover estimated losses inherent in the loan portfolio.

To determine whether a bank's allowance for loan losses is reasonable, the CPA firm auditing the bank must (Bank Audit Guide p. 63):

> ... identify individual loans or conditions that require further consideration in evaluating the reasonableness of the allowance. Factors include
>
> - Current trend of delinquencies.
> - Loans classified by supervisory agency examiners.
> - Excessive loan renewals and extensions.
> - Absence of current financial data related to borrowers and guarantors.
> - Borrowers experiencing such problems as operating losses, marginal working capital, inadequate cash flow, or business interruptions, such as involuntary conversions due to fire loss or condemnation.
> - Loans secured by collateral that is not readily marketable or is susceptible to deterioration in realizable value.
> - Loans in industries experiencing economic instability.
> - Inadequately documented loans.

The federal bank regulatory agencies (the Federal Reserve Board, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation) also have issued examination procedures to be followed in evaluating the adequacy of a bank's loan loss reserve for GAAP purposes.

Section 217.1 of the Comptroller's Handbook for National Bank Examiners deals with the allowance for loan and lease losses of national banks. In part the section provides that "[m]anagment's determination of the amount of the appropriate valuation allowance is an estimate, the adequacy of which should be tested by the examiner." The Handbook goes on to state:

> Historical data often is the foundation on which an estimate of the losses existing in the loan portfolio is built. Such data, much of which is included in the Uniform Bank Performance Report, may include, but is not limited to:
>
> - Amount of loans at the most recent review date and at comparable dates in prior years.
> - Amount of valuation allowance at the most recent review date and at comparable dates in prior years.
> - Provisions for possible loan losses for the past several years.
> - Excess or deficiency of provision for possible loan losses over actual amount of such losses for the past several years.
> - Loan loss experience, charge-offs and recoveries, in the past several years in total and by major loan categories.
> - Ratios of net charge-offs to average loans for several years.
> - Ratio of allowance for loan and lease losses to average loans for several years.
>
> Historical data, whether expressed as amounts or ratios, or formulas based on such data, however, provide only a portion

> of the information necessary to evaluate the adequacy of the allowance. An assessment of the effectiveness of the bank's lending policies and procedures and any changes relating thereto is equally important. Such information, combined with the results of periodic comprehensive reviews of the loan portfolio, provides a sound basis for estimating loan losses and assessing the effect of current economic conditions and other factors on the applicability of historical data in projecting trends. (Emphasis added.)

To evaluate the adequacy of management's estimate of the loan loss reserve, national bank examiners are instructed to consider various information. Specifically, the Handbook provides:

> Such information includes, but is not limited to:
>
> ° Evaluation of lending policies, practices and internal controls.
>
> ° Loans classified and commented on in the current examination, including those on management's list of loans deemed less than 100 percent collectible.
>
> ° Current trend of delinquencies.
>
> ° Listings of aged past-due loans, loans on which interest is not being collected in accordance with the terms of the loans, and loans whose terms have been modified by reducing the interest rates or deferring interest. Such listing should include borrower's current financial conditions, collateral value and any third party reliance.
>
> ° Excessive loan renewals and extensions.
>
> ° Results of discussions with bank officers and employees.
>
> ° General or local economic conditions that might have a

bearing upon the collectability of loans, such as pronounced business depression, closing of a large number of plants in an industry, widespread labor strikes or international trade barriers because of war or exchange restrictions.

- All available outside information of comparable nature regarding banks of similar loan portfolio size, composition and quality.

> Loan losses, whether actual or estimated, may vary greatly even among banks with loan portfolios of similar size, composition and quality. Accordingly, information from peer group banks should be used only as general guidelines and never as the sole determining criteria for establishing an appropriate allowance.
>
> The allowance for loan and lease losses should be sufficient to cover those loans classified as loss in the report of examination, some applicable percentage of other classified loans and estimated potential losses on the loans in the portfolio not classified during the current examination.

Based on the above quotations from the Bank Audit Guide and the Comptroller's Handbook, it is clear that both the accounting profession and the bank regulatory agencies interprete GAAP to mean that the loan loss reserve of a commercial bank is adequate when such reserve balance is sufficient to cover the losses inherent in a bank's loan portfolio at a point in time. Accountants and regulators also recognize that factors other than historical experience are important in determining the proper level of the loan loss reserve.

S. 1263, introduced by Senators Roth and Boren (and H.R. 2854, introduced by Congressmen Flippo and Frenzel), would provide for conformity between the reserve for loan losses required for tax purposes and those required for financial statement purposes. The bill does contain some limits, however, on the amount of the bad debt deduction a bank may claim. In introducing the bill, Senator Roth correctly states that "... the safety and soundness of our banking system will be enhanced." Senator Boren went on to state:

> In drafting the bill, we have also provided safeguards so that commercial banks will not be able to claim excessive loan loss reserves for book, and therefore tax purposes. For most commercial banks, the marketplace should provide enough certainty that reserves are not overstated. The directors are under pressure to maintain dividends, and stock values, and therefore have an incentive not to reduce earnings by overstating reserves. The accounting practices are also subject to scrutiny by several Government regulatory authorities, and by outside auditors.

The safeguard referred to by Senator Boren is the limitation that the maximum book loan loss reserve to be taken into account for Federal income tax purposes cannot exceed 1.5 percent of total loans.

* * * * * * * * * * * *

The tax reform proposals (H.R. 3838, Treasury I, and Treasury II) all contain provisions eliminating the use of the reserve method of accounting for loan losses for commercial banks. The logic behind such bad debt reserve provisions is seriously flawed as (i) current law does not provide any mechanism for commercial banks to reduce their tax liability by manipulating their bad debts; (ii) the mechanical bad debt formula uses old historical data resulting in the reserve balance being significantly understated; and (iii) permitting banks a bad debt deduction only when a loan is charged off ignores economic reality.

Commercial banks should be permitted the continued use of the reserve method of accounting for loan losses. Furthermore, GAAP provides a more appropriate means of measuring the adequacy of a bank's loan loss reserve balance than does existing law.

DC18:40

LAW OFFICES OF
BRUCE JOHNSON

1701 Arch Street
8th Floor
Philadelphia, Pennsylvania 19103
(215) 587-6167

1718 Connecticut Avenue, N.W.
Suite 310
Washington, D.C. 20009
(202) 939-8391

March 7, 1986

The Honorable Jake Garn
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
Dirksen Senate Office Building
Room SD-534
Washington, D.C. 20510

RE: Hearings on H.R. 3838

Dear Mr. Chairman:

In connection with the Committee's recent hearings on H.R. 3838 and the implications of tax reform on real estate and the economy, I would respectfully request that the following statement be included in the Record of the hearings.

The focus of my comments is the lack of inclusion in H.R. 3838 of provisions to remove impediments to the growth of the mortgage backed securities market and the development of the new asset-backed securities market. Several bills have been introduced in the Senate to remedy this default including S. 1978 sponsored by Senator Alan Cranston and co-sponsored by Senators Dodd, D'Amato, Dixon, Mattingly, and Riegle. In addition, I know that you and Senator Proxmire have written to Secretary of the Treasury James Baker expressing your interest in this important area. Thus, it appears that a majority of the Committee on Banking, Housing and Urban Affairs is favorably disposed to legislative action in this area to remedy the defects of H.R. 3838.

Very truly yours,

Bruce Johnson

BJ/ms
Enc.

The Importance
# of Including
Receivables and Other Assets
In
Federal Tax Legislation
To
Authorize Multiclass
Pass-Through Securities

February 27, 1986

Introduction

The Congress has before it several legislative proposals (S.1959 and S.1978) to amend the Internal Revenue Code to remove certain impediments to the ability of American businesses and consumers to meet their funding needs in the most efficient manner. The cornerstone of several of these legislative proposals is the authorization of a multiclass pass-through security as a means of facilitating the securitization of home mortgages, receivables, and other assets. S.1959 focuses solely on mortgages. S.1978 focuses on mortgages, receivables and other assets.

The Department of the Treasury in testimony on January 31, 1986 before the Senate Subcommittee on Taxation and Debt Management stated that:

> "...although multiple class pools of auto loans, lease receivables, corporate bonds and other obligations would appear closely similar in concept to multiple class mortgage pools, we believe it is appropriate to proceed with some caution in this area. Thus, we believe it appropriate that we gain experience with multiple class mortgage pools before extending the concept of issuer level tax exemption to multiple class pools of other debt obligations. Moreover, because of real estate mortgages' typically long term and significant incidence of prepayment, they present the most pressing case for the allowance of multiple class arrangements."

This memorandum seeks to justify the inclusion of non-mortgage receivables and other assets such as automobile receivables, consumer loans and commercial loans in any tax legislation that moves forward in the Congress to authorize the use of multiclass pass-through securities and to respond to the concerns of the Department of the Treasury in this regard. We agree with what Senator John Chafee (R-R.I.) said in introducing S.1959 that this legislation: "... is strictly a tax bill that does not address any credit policy issues, or differentiate among different types of securities on the basis of credit policy concerns, and consequently debate ... should be confined to tax policy issues."

In modernizing the tax laws to effect greater efficiency in any segment of the nation's economy, the Congress and Department of the Treasury should not advance the competitive position of some market participants or hobble the abilities of others. It would be intolerable to use the proposed legislation as a vehicle for reshaping the nation's credit policy. We believe that mortgages and non-mortgage receivables should be placed on a level playing field with respect to any credit made available by these legislative proposals.

Similarity of Mortgage and Non-Mortgage Receivables

Over the last decade we have gained tremendous insight into the process of securitizing mortgages to the benefit of investors and issuers. That knowledge has included a greater understanding of prepayment patterns, the average life of a security and the needs of investors. In recent years we have begun to apply that experience to receivables and other assets. Whether they are secured by an interest in real property or secured by an interest in personal property or are unsecured; we find that mortgage and non-mortgage receivables are surprisingly similar. Certain non-mortgage assets, which we will call receivables, are simply amounts owed to an entity by another. In both cases, the loan payments are the obligations of the borrower and, indeed, the receivables are the obligations of the lender. The security interest in the property that is granted by the borrower to the lender is merely to secure the borrower's promise to pay the lender and becomes important only if the borrower does not pay. In both instances lenders will require borrowers to provide security for their promises to pay to the extent and in the amount they think necessary to protect the value of their mortgage or receivable.

The securitization process begins with developing a detailed understanding of the legal and financial terms of the receivables, including any security interest supporting

The Importance of Non-Mortgage Receivables

The multiclass format has historically been used predominantly for the securitization of debt instruments collateralized by mortgages. However, the multiclass securitization of debt instruments collateralized by non-mortgage assets and sales of non-mortgage receivables in pass-through structures are developments which were not consciously excluded from earlier efforts to facilitate the securitization of mortgages. They had not yet been invented.

It would be incongruent to divide the capital markets by permitting one form of assets, mortgages, to be more easily securitized versus other types of assets. Although home ownership is an important goal for many Americans it is clear it is not the only necessity. Decent health care, jobs, food, suitable clothing, affordable transportation, furniture and home furnishings in most instances are modern life necessities.

The ability to obtain any or all of these items obviously is dependent on a number of factors, most of which are financially related. Our experience with securitizing mortgages tells us that accessing the capital markets results in greater availability of money for home building, lower mortgage interest rates and a stronger home building industry. Similar benefits will accrue to issuers of and investors in multiclass receivable securities as well as consumers.

the receivable. Based upon this analysis a security structure is devised to find the best possible accomodation of the characteristics of the receivable and the requirements of the investors. The reasons for the Congress and the Treasury not to object to placing all types of mortgages and receivables on a level playing field can be illustrated by considering the following three examples. All three security interests have a remaining term to maturity of 48 months, a current principal balance of $10,000 and an interest rate of 12 percent per annum. All three receivables are subject to prepayment. Receivable 1 is an automobile loan that provides for 48 monthly payments of $263.34. Receivable 2 is a seasoned single family mortgage loan that has remaining 48 monthly payments of $263.34. Receivable 3 is an interest only commercial real estate loan that provides for 47 monthly payments of $100 followed by a payment of $10,000.

We fail to be able to distinguish differences between these security interests, mortgages or receivables for tax purposes.

Benefits to Issuers

More and more receivables are being securitized to restructure the cash flows generated by such receivables. A receivable financing enables an issuing company to achieve certain benefits including:

- lower financing costs, particularly for issuers for which the receivables are high quality assets;
- eliminating the ongoing funding uncertainty of owning receivables by directly funding these receivables;
- shrinking the balance sheet through off-balance sheet accounting treatments; and
- presenting new business opportunities for companies which can originate high quality receivables, sell them in multiclass securities and retain upfront fee and ongoing servicing income.

These techniques offer tremendous opportunity for improving the financial health of a broad range of corporate issuers. It is no secret that the 1970's and the 1980's have been periods of increasing leverage and declining credit quality among major corporations. This trend has limited the access of many of these corporations to traditional and more expensive sources of capital. The ability to pool and liquify high-quality receivables in a multiclass pass-through can reduce leverage and increase credit quality. The cost of capital and credit will be reduced by the inclusion of receivables in any multiclass pass-through legislation.

Benefits to Consumers

The inclusion of other recievables also attempts to respond to the recent concerns of the public and the Congress about high interest charges on credit cards and other consumer loans to consumers. S.1978 by authorizing a new attractive securities marketing feature will allow companies making consumer loans to finance these assets at substantially lower costs. It will also allow them to securitize and sell securities collateralized by these loans which should provide them additional liquidity and new fee income as an alternative to artificially high interest rates. Indeed, the inclusion of other receivables is a logical alternative to recently proposed legislation to cap interest rates on credit card loans. The inclusion of other receivables would be highly beneficial to consumers because it will help reduce interest costs to them on financial purchases of these assets.

By way of illustration consider this simple example. A borrower would like to buy a new car and would like to finance that purchase with a four-year loan. An automobile finance company will lend the borrower the funds needed at an interest rate that will depend in turn on the automobile finance company's cost of borrowing or alternately on the price the automobile finance company would receive if it could sell the borrower's loan to investors. Investor A would like to purchase only the first year of borrower's loan. Investor B, on the other hand, would be happy to purchase the second, third and fourth years of the loan. If either Investor A or Investor B has to buy a part of the loan that does not meet his needs he will pay a lower price - if he is still willing to purchase at all.

The ideal situation to the automobile finance company's funding needs is obvious: sell Investor A the first year of borrower's loan and sell Investor B the remainder. Current tax law, however, does not allow the automobile finance company to do the logical thing. It cannot sell Investor A the first year of the loan and Investor B the remainder without incurring an additional level of tax that destroys the economics of the transaction. That result leaves the automobile finance company with two less desirable choices. The automobile finance company can either sell Investors A and B something that neither truly wants in exchange for a lower price, or alternatively, keep the loan in its portfolio and increase its borrowings knowing that such additional borrowings likely will increase the interest rate and maturity mismatch of the automobile finance company's assets and liabilities, adversely affect its debt to equity ratio, and generally detract from its ability to borrow. All of which means the American consumer would have to pay more interest than an efficient market otherwise requires.

The Role of Multiclass Securities in Reducing Interest Rates

The nation would welcome lower interest rates to spur the economy which in turn would help to reduce the Federal budget deficit. The enactment of multiclass pass-through tax legislation along the lines of S.1978 would help reduce interest rates in several key sectors of the economy, consistent with the goals of the Gramm-Rudman balanced budget legislation. In earlier issuances of debt securities collateralized by mortgages and utilizing a multiclass structure, savings in costs of funds on various issues of as much as 90 basis points or 9/10 of one percent resulted. It is our belief that the use of such structures in the mortgage market resulted in anywhere from 1/8 to 3/8 of a percent reduction in overall mortgage interest rates. If the multiclass structure were made available to all types of pass-through securities; the result would be lower interest costs in those sectors of the economy where multiclass pass-throughs become popular financial vehicles. Of course, as multiclass securities become more generally available this differential is likely to decrease. However, we believe that the potential for slight reductions in interest rates is real and meaningful, especially if the economy wants to escape recessionary pressures.

Specific Benefits to Financial Institutions

One of the greatest risks that commercial banks and thrifts face is interest rate risk. This is created by the funding of longer-term fixed rate assets by shorter-term deposits and borrowings. The substantial portion of these interest rate insensitive assets are held in the form of real estate, consumer and automobile loans. Some of these institutions partly manage the risk of these holdings by relying upon asset sales. These asset sales can improve the profitability of these institutions. First, asset sales reduce the institutions' portfolio risk to interest rate swings by improving the maturity match of its assets and liabilities. Second, asset sales increase the institutions' liquidity by quickly converting loans into cash. Finally, asset sales boost the income of these institutions by increasing their fees from the origination, securitization, and servicing of loans. If receivables and other assets were allowed to be used in multiclass pass-throughs these institutions would be encouraged to sell and securitize more of the assets in their portfolios and, thus, reduce their interest rate risk.

Let me give you some other examples of how this could benefit financial institutions and be consistent with some recent regulatory changes in bank reporting requirements. On October 25, 1985 the Federal Financial Institution

Examination Council gave insured banks new incentives to issue multiclass pass-through securities. The Council did this by reversing the way in which asset sales are reported in banks' periodic Call Reports. These revisiions greatly facilitate asset sales. The Call Reports previously instructed banks to apply two different criteria to distinguish between sales and borrowings. There was a risk criterion and a term criterion. The risk criterion asked whether or not the owner retained any risk in connection with the asset transaction. The term criterion asked whether or not the terms of the sale instrument were identical to those of the underlying asset.

Previously, if any risk was retained or if the terms were not identical, the transactions were reported as borrowings in the Call Report. The revised Call Report instructions basically retain the first risk criterion but shed the second term criterion. This facilitates the issuance of multiclass pass-throughs where the terms of the varying classes of securities differ from those of the two underlying assets.

Commercial banks, for example, should benefit by now being able to more economically securitize and sell student loans, automobile loans, agriculture loans, commercial loans, and other loans to investors. In light of their existing portfolios of troubled assets in the farm and lesser developed countries areas, this should add liquidity and new sources of fee income.

Thrifts, which in recent years have been the hardest hit by the high cost of financing their assets, would benefit greatly from inclusion of other receivables in any multiclass pass-through tax legislation. These legislative proposals could also provide them new sources of fee income. It will mitigate against loan losses on commercial and consumer loans as thrifts diversify into these new lending areas.

Specific Benefits to Commercial Property Developers and Insurance Companies

The emergence of a successful secondary market for residential mortgages has spurred increasing interest in the development of a secondary market for commercial property mortgage-backed securities. In 1984 and 1985 development of this market has accelerated. In that time an estimated $4 to $5 billion of commercial mortgages have been sold to investors, including many of the nation's largest insurance companies. Experts estimate outstanding mortgage debt for commercial properties at more than $500 billion. This includes mortgages on developments such as shopping centers, office buildings and hospitals.

Advantages of a commercial real estate mortgage-backed security market with a multiclass feature include increased liquidity for lenders, greater flexibility for borrowers and competitive yields for investors. Without a cost efficient secondary market for commercial mortgages lenders of commercial loans find themselves in the position of having to hold those loans in portfolio until they are paid off.

Developers and corporations would have more flexibility in financing their operations with a multiclass pass-through security. Because of the huge dollar amounts usually required for commercial development, the number of investors who have the wherewithall to accomodate such large investments is limited. For these investors a multiclass pass-through would allow them to purchase portions of the projects that fit their yield and portfolio requirements. The major purchasers of such interests have previously been large insurance companies which could use this new marketing feature to increase their returns and restructure their portfolios.

Specific Benefits In Reducing Government Agency, Corporate, and Consumer Debt Burdens

The debt burden on governmental agencies, corporations and consumers has climbed to more that $8 trillion, ten times the level of debt a quarter century ago. As the debate over the implementation of the Gramm-Rudman law to balance the budget intensifies a surprising number of economists are questioning more and more our ability to manage our indebtedness. Some economists are worried about the corporate debt situation because when you have very little equity and a lot of debt then even a mild recession can cause economic difficulties. The worry is that debt is growing far faster than income and assets for many types of borrowers. Total debt has climbed on average eleven percent this decade, while the economy has grown only at eight percent.

Since 1977 consumer debt has risen from 17 percent of income to a record 19.4 percent. The debt-to-equity ratio of businesses has soared from about 68 percent to 92 percent and the Federal debt has leaped from 35 percent of GNP to a stunning 47 percent. The total size of credit market debt outstanding including institutional debt is somewhere between seven and eight trillion dollars today. In 1970 it was about one and one half trillion dollars and at the beginning of 1960 it was 700 billion dollars. In recent years businesses have borrowed as the economy has expanded but they have not increased their equity.

For example, financial institutions, because of financial deregulation, were able to pay savers any yield to attract funds and now lend these funds more aggressively than ever before. In a much more competitive environment it is a matter of survival for banks to be able to lend as much as possible.

So far the price the economy has paid for the growing debt has not been very high but the causes for concern are beginning to multiply. Falling commodity prices have spelled disaster for the nation's farms. Plunging oil prices have jeopardized numerous oil related companies with excessive debt to service. And the level of non-performing loans at banks and thrigts has risen sharply. The consequences of an excessive growth of debt faster than income either means that when there is a recession in the future it will be more severe and more dangerous or that inflationary measures will be taken so that people can pay their debts in depreciated currency.

Receivable-backed multiclass pass-through financings will be of substantial benefit to many companies that are highly leveraged and/or cannot support additional debt burdens on their balance sheets. Companies could use these efficient securities to sell assets and become "asset bankers" rather than continuing to borrow extensively. The sale of these assets or receivables would fund originations of new assets or receivables. It would also provide them with additional liquidity and a real start toward reducing the nation's excessive reliance on debt.

Even Federal Reserve Board Chairman Paul Volcker has in recent days expressed concern about the rapid rise in corporate debt and has urged Congress to consider tax law changes that would discourage excessive corporate borrowing.

No Competition Between Short-Term Multiclass Issues and Treasury Issues

The evidence is that multiclass issues utilizing short-term assets will not compete with Treasury's own shorter-term issues. It is true that spreads between GNMA pass-through securities (pools of FHA-insured mortgages) and longer-term Treasury debt have fallen rapidly since the introduction of multiclass mortgage-backed debt securities. In the month before the first multiclass mortgage-backed debt security (May 1983) the spread between GNMA 13s and 10-year Treasuries averaged 215 basis points, by June 1984 it was only 88 basis points.

With respect to current issues of receivable-backed debt or pass-through issues the spread between these issues and shorter-term Treasuries has ranged from 37.5 basis points (over 18 month Treasuries) to 75 basis points (over 2-year Treasuries). We expect that multiple class features will reduce these spreads further to a range of 30-50 basis points over shorter-term Treasury securities.

However, we believe that even with such reductions the spread between Treasuries and these issues is extensive enough to prevent substitution, will remain extensive enough and likely widen over initial reductions as these securities gain acceptance in the marketplace.

Examples of Potential Receivables for Securitization*

- act of sales and chattel mortgage with an accompanying promissory note evidencing the sale and grant of a lien on or a security interest in personal property (form of residential security in Louisiana)
- automobile loans
- computer leases
- contractual utility payments
- cooperative apartment unit loans (residential loans secured by stock; form of residential security in New York and in many other states)
- credit card receivables
- crop loans
- export financing receivables
- installment sales contracts
- investor notes
- lease receivables
- long-term residential leases (form of residential security in Hawaii)
- major appliance loans
- mobile home loans (treated as consumer loans in many States)
- second mortgage loans (treated as consumer loans in many States)
- small business loans
- student loans
- telephone leases
- term bank loans

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* S.1959 would not apply to these receivables. They would be included under S.1978.

Recent Public Issues

Recent public issues include:

- Sperry Corporation's $192 million of lease-backed notes. These notes were AAA rated publicly offered securities with an average life of 2 years. The deal was priced at +50 basis points to the 2-year Treasury.
- Marine Midland's $60 million of automobile receivables certificates. The notes were AAA rated publicly offered securities with an average life of 18 months. The deal was priced at +37.5 basis points over the 18 month Treasury.
- Valley National's $100 million of asset pass-through certificates. The notes were Aa1 rated publicly offered securities with an average life of 1.9 years. The deal was priced at +43 basis points to the 2-year Treasury.
- Home Federal's $110 million of automobile receivables certificates. The notes were AAA rated publicly offered securities with an average life of 2 years. The deal was priced at +75 basis points over the 2-year Treasury.
- Sperry's second issue of $146 million of lease-backed notes. These notes were AAA rated

publicly offered securities with an average life of 2 years. The deal was priced at +70 basis points to the 2-year Treasury.

- General Motors Acceptance Corporation's issue of $524 million of automobile receivables pass-through certificates. These certificates were AAA rated publicly offered securities with an average life of approximately 2 years. The deal was priced at approximately +50 basis points to the 2-year Treasury.

Tax Aspects of Receivable-Backed Securities

Issuers of and investors in receivable-backed pass-through securities are taxed in a manner similar to issuers of and investors in mortgage-backed pass-through securities. In general, the seller since he has disposed of his entire ownership interest of the non-mortgage receivables, realizes a gain or loss on the sale measured by the amount received from the purchaser, minus his entire basis. Thereafter, he reports any servicing spread as income as received. The investor, on the other hand, reports the entire income at the underlying coupon rates on his undivided percentage of the receivables, and deducts the servicing spread to the extent, in the words of the IRS, it represents "reasonable compensation for services rendered."

Existing receivable-backed pass-throughs describe the entire spread and servicing and do not distinguish between "excess servicing" and "reasonable servicing." However, at some point servicing compensation could leave off and a retained economic interest begins. When the securitized receivables are interest bearing obligations, such as mortgages, commercial loans, or automobile receivables, the economic interest can be characterized as a stripped coupon or stripped bond under Internal Revenue Code rules enacted in 1982. The most familiar types of stripped interests are stripped Treasuries and the same rules or concepts should apply to any partial coupons or principal payments in receivable-backed pass-through securities. In the case of excess servicing, since the interest of the seller and the investor are fixed, there should be no problem. Leases, however, do not have the protection of the coupon stripping exception and the magnitude of servicing compensation in those deals may be of greater concern.

Let me explain. Under coupon stripping the seller of leases would have to allocate part of his overall basis to the future income stream. The seller would, therefore, report either loss or a larger gain on the sale, and would accrue the difference between the basis allocated to the income stream and its face amount as if it were original issue discount. The purchaser would similarly have to allocate his overall basis among the future cash flows and report the differences with the face amount of such cash flows as original issue discount. As a practical matter, the seller will most likely have to perform these calculations and report them to the IRS. However, due to the absence of rules describing when this is appropriate and the lack of Treasury regulations on original issue discount or coupon stripping most tax counsel will recommend the traditional practice used in mortgage-backed pass-through securities of describing the entire spread as compensation for services and set forth the possible alternative treatments in the prospectus.

Conclusion

In conclusion, we believe there are no reasons to discriminate against the inclusion of receivables and other assets as qualifying assets for favorable tax treatment in multiclass pass-through securities legislation. We see no substantial tax policy, credit policy or technical problems in including receivables and other assets.

Appendix

	Exhibit
1985 Asset-Backed Securities Public Issues - Summary of Terms	A
Support for Inclusion of Receivables and Other Assets	B

1985 -- ASSET-BACKED SECURITIES -- PUBLIC ISSUES

SUMMARY OF TERMS

Issuer/Parent	Amount	Date	Collateral	Underwriter
Sperry Corporation	$192M	5/8/85	Computer Leases	FBC
Valley National Bank	$100M	5/15/85	Automobile Receivables	FBC
Marine Midland Bank	$60M	5/15/85	Automobile Receivables	Sal
Home Federal S & L	$103M	5/15/85	Automobile Receivables	Sal
Sperry Corporation	$146M	9/12/85	Computer Leases	FBC/ Bear Stearns
General Motors Acceptance Corporation	$525M	9/12/85	Automobile Receivables	FBC

SUPPORT FOR INCLUSION OF RECEIVABLES AND OTHER ASSETS

(S.1978)

The First Boston Corporation

Morgan Stanley & Co. Inc.

Shearson Lehman Brothers Inc.

Security Pacific Corporation

Chrysler Financial Corporation

Beneficial Management Corporation

American Financial Services Association

Sears, Roebuck & Company

American Bankers Association

By Mr. CRANSTON (for himself, Mr. D'AMATO, Mr. DIXON, Mr. DODD, and Mr. MATTINGLY):

S. 1978. A bill to clarify the taxation of certain asset-backed securities in multiple class arrangements; to the Committee on Finance.

RECOVERY ACT FOR MORTGAGE AND OTHER ASSET-BACKED SECURITIES

Mr. CRANSTON. Mr. President, today I am introducing a bill to eliminate impediments to the growth of the mortgage-backed securities market and to permit the development of the new asset-backed securities market. This legislation would amend the Internal Revenue Code to permit the issuance of multiple class passthrough securities backed by pools of mortgages or other assets under the grantor trust rules of the Internal Revenue Code. Other assets include consumer loans, commercial real estate mortgages, and commercial leases.

The secondary mortgage market provides billions of dollars in credit each year to finance home ownership by enabling originators of home mortgages such as thrift institutions and mortgage bankers to resell mortgage loans to investors in the form of mortgage-backed securities. Recently, the first such securities backed by automobile receivables and consumer loans have come to market. An efficient secondary market lowers the cost of funds for that particular market, making it possible for originators: To make mortgage funds available to homebuyers at lower interest rates, to make car loans available at lower cost and, make other types of consumer loans available at lower cost. Under this proposal originators of all types of loans or assets will be able to sell loans or assets in a more efficient manner to other investors for cash and use the new funds to continue the lending process.

There is approximately $300 billion of outstanding mortgage securities in the secondary market. Purchasers of mortgage backed securities include banks, thrift institutions, pensions and other retirement funds, insurance companies and other institutional as well as individual investors. The first issuance of securities backed by pools of mortgages ever accomplished was done under title 8 of the Housing Act of 1968 by the Federal National Mortgage Association [FNMA]. One of my constituents from California, Ray Lapin, the First President of FNMA while it was still a part of the U.S. Department of Housing and Development, devised the concept of putting the full faith and credit of the U.S. Government behind securities backed by pools of FHA-VA mortgages. The success of those securities led to the development of the secondary market as we know it today. Mr. Lapin can truly be said to be the "father" of the secondary mortgage market.

Since that time, the secondary mortgage market has developed a variety of mortgage-backed securities that have been attractive to investors in terms of safety, yield, and investment performance. However, because residential mortgages are subject to prepayment at uncertain intervals, the traditional mortgage security lacks call protection—assurance that the investment will have a definite maturity. The lack of call protection—from a cash payment occurring before the stated maturity to the investor—causes investors to demand a higher yield on moneys invested in these securities. This higher cost of funds is passed on to homebuyers and othe participants in the market.

Many investors have differing timing needs in structuring their investments. If one pool of mortgages could be structured to pay off on several maturity dates, that is—2 years, 5 years, 10 years et cetera—investors could select the maturity date most compatible with their investment needs. This concept is call the multiple class mortgage-backed passthrough. This multiple class feature would add more predictability to this instrument thereby reducing the demand for higher yields on these securities.

Presently the tax laws, most of which were enacted prior to the development of mortgage-backed securities, have made it difficult to structure securities that provide call protection, as well as securities that rearrange the cash flows from mortgages to create different maturity classes.

The fixed investment trust vehicle, traditionally used to market pools of mortgages in securitised form without tax liability at the pool level, has been interpreted to restrict the flexibility necessary to provide call protection even to a limited extent and the ability to structure different classes of investors with different maturities as defined by proposed treasury section 301. 7701-4(c) published in the Federal Register on May 2, 1984. In early 1984, Sears Mortgage Securities Corp. along with Dean Witter pioneered the development of a multiple class, mortgage-backed passthrough security. The security was set up under the grantor trust rules with multiple classes of ownership and consistent with private letter rulings from the Internal Revenue Service. Two months later the IRS promulgated draft regulations that espoused the view that multiple class shares in collateral pools violate the passive requirement of the grantor trust form. However, the initial Sears/

Dean Witter issue was grandfathered. A public hearing was held by the IRS on the proposed regulation on July 31, 1984. At that hearing, numerous witnesses, including the public securities Association, the Mortgage Bankers Association of America, the National Association of Home Builders, Sears' Mortgage Securities Corp., Dean-Witter Reynolds Inc., Norwest Mortgage Co., the Lomas & Nettleton Co., the First Boston Corp., Solomon Bros., and the gentleman from Texas, Congressman STEVE BARTLETT, all testified in opposition to the regulation. The witnesses described the negative effect of the regulation on the mortgage-backed securities market, and why the use of multiple class fixed investment trusts should be differentiated from Treasury concerns regarding other tax deferral investment proposals.

The Bankers Association of America testified:

> We cannot overemphasize the importance of multiclass mortgage passthrough instruments to all parties involved.
>
> We find no legal or tax rationale for the consequences of these regulations that would treat certain multiclass mortgage passthrough arrangements as a 'corporation' instead of a trust for tax purposes.

The Public Securities Association stated:

> From a public policy perspective, the use of multiple class passthrough custodial arrangements are desirable because investments in traditional 30-year mortgage passthrough securities are somewhat limited, and this new structure, by providing various maturities, will attract many new institutional investors to participate in the mortgage-backed securities market.
>
> We can conceive of no reason why it is sound tax policy, or sound public policy, to pursue adoption of the proposed amendments without a specific exception permitting multiple class mortgage passthrough arrangements to be classified as fixed investment trusts, and not associations taxable as corporations.

The National Association of Home Builders stated:

> The recent development of multiple maturity mortgage investments has been extremely beneficial for the housing industry and American homebuyers.
>
> Mortgage-backed securities, the principal tool for raising mortgage money in the capital markets, have had higher yields than other similar investments because of the unpredictable prepayment of the underlying mortgages which makes management of mortgage pass-through portfolios more difficult than for other similar investments. The development of multiple class mortgage investments has substantially reduced the investment risk problems associated with direct investment in mortgage-backed securities. These multiple class investments, by virtue of more predictable maturities, typically have had significantly lower yield requirements than other mortgage-backed securities.

Dean Witter Reynolds, Inc./Sears Mortgage Securities Corp. stated:

> . . . offering 'fast-pay-slow-pay' interests in mortgage pools is desirable, because the different interests have different investment characteristics and appeal to different classes of investors.
>
> We think it is wrong as a matter of legal analysis and tax policy not to exclude multiple class mortgage-pass-through arrangements from the amendments proposed . . .

I would like to insert in the RECORD at this time more recent letters supporting the multiclass mortgage-backed passthrough.

There being no objection, the letters were ordered to be printed in the RECORD, as follows:

MORTGAGE BANKERS
ASSOCIATION OF AMERICA,
Washington, DC, July 31, 1985.

HON. ALAN CRANSTON,
U.S. Senate,
Washington, DC.

DEAR SENATOR: As you know, the Mortgage Association of America has been most interested over the past several years in the development of a multiple class mortgage-backed pass-through security that would not be subjected to the restrictions embodied in the grantor trust tax treatment under the Internal Revenue Code. We view this mechanism as an excellent opportunity for the attraction of needed additional investment capital for one of our country's most important goals—creation and maintenance of an adequate national stock of housing.

We are most pleased that you are in the process of crafting legislation, the "Mortgage-Backed Securities Legislative and Regulatory Improvements Act of 1985," that would authorize the creation of such a security. We would be happy to work with you and your staff in exploring the effect your proposal would have on the market and in offering any possible technical drafting assistance. And, of course, at such time as Congressional hearings might be scheduled on the subject, we would very much appreciate the opportunity to appear and testify in support of the concept.

We understand that group of investment banking firms has designed a similar proposal and have also indicated to them our interest and support in this matter.

Our goal, of course, is the development of the most effective instrument that could be put in place as quickly as possible. We would hope that all interests involved in this effort could agree on a mutually satisfactory course of action.

Sincerely,

NATIONAL COUNCIL OF
SAVINGS INSTITUTIONS,
October 7, 1985.

HON. ALAN CRANSTON,
Senate Hart Office Building,
Washington, DC.

DEAR SENATOR CRANSTON: On behalf of the National Council of Savings Institutions, I would like to offer some observations on draft legislation prepared by your staff entitled the "Recovery Act for Mortgage-Backed Obligations" (RAMBO).

This legislation recognizes that tremendous change has happened in the mortgage markets in the past five years. The liquidity of mortgages has increased substantially, and the volume of trading in mortgages and mortgage-related investment vehicles has also grown.

Not only has the use and volume of mortgage-backed securities grown over the past decade, the creativity applied by the market to these instruments has mushroomed. Savings institutions now use mortgage-backed securities in their asset management. As the need to put old loans in portfolio to use, savings institutions are issuing collateralized mortgage obligations, mortgage-backed bonds, and preferred stock. In the majority of these transactions, mortgage-backed securities, not the mortgages themselves, are used as the collateral.

However, the ability to best utilize mortgage-backed securities, both from the investor and issuer point of view is hampered by tax law. The passive management requirements imposed by the grantor trust provision of the tax code have limited mortgage-backed securities. Your legislation addresses this fundamental weakness in the current structure for mortgage-backed securities.

At the present time, we would like to reserve our technical comments on your legislation. However we would like to express support for your efforts and urge that you introduce legislation in this important area.

Kind Regards,

JOHN H. ROUSSELOT

AMERICAN BANKERS ASSOCIATION,
MORTGAGE BANKERS ASSOCIATION OF AMERICA, NATIONAL ASSOCIATION OF HOME BUILDERS, NATIONAL ASSOCIATION OF REALTORS, NATIONAL COUNCIL OF SAVINGS INSTITUTIONS,
October 17, 1985.

HON. BOB PACKWOOD,
Chairman, Committee on Finance,
U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: It is our understanding that legislation is currently being drafted that would amend the tax laws to permit the issuance of multiple-class securities backed by a single pool of mortgages.

The undersigned organizations strongly support proposals that would remove tax liability at the pool level for multiple-class mortgage pass-through securities set up under specified guidelines. With these tax law amendments, multiple-class pass-through securities could be issued that would resemble collateralized mortgage obligations (CMOs) and offer investors a choice of maturities. This would lessen the unpredictability of prepayments and permit issuers to sell mortgage assets at higher prices than can be commanded by using secondary market instruments currently available to them. Thus, issuers could have the benefits of CMOs as well as sale-of-assets treatment for accounting purposes. In turn, homebuyers would realize a benefit in terms of lower interest rates that would result from more favorable secondary market pricing. Indications are that any revenue loss to the Treasury would be negligible.

We, therefore, respectfully urge Congress to hold hearings on this matter and to pass legislation that would authorize these types of multiple-class mortgage securities. Such legislation would expand the universe of investors willing to purchase mortgage products because such securities could be fashioned to accommodate differing investment needs. Pricing benefits would accrue to homebuyers in the form of lower interest rates, and there would be no significant loss to the Treasury.

Sincerely,

JAMES C. CAIRNS,
President,
American Bankers Association.
RONALD P. POE,
President,
Mortgage Bankers Association of America.
JOHN J. KOELEMIJ,
President,
National Association of Home Builders.
DAVID D. ROBERTS,
President,
National Association of Realtors.
KENNETH P.X. ALBERS,
Chairman of the Board,
National Council of Savings Institutions.

Mr. CRANSTON. Mr. President, Treasury officials could promulgate final regulations by the end of January 1986 on these issues, however, from my conversations with them, they have indicated that they will not substantially amend the regulations with respect to mortgage-backed securities trusts to allow the use of multiple class passthrough securities. They have given indications that they would like some guidance from the Congress on this matter. I believe this legislation would provide such guidance.

My bill simply overrides the proposed draft regulations prohibiting multiclass passthrough securities under the grantor trust rules. This proposal provides that multiclass passthrough securities that do not have active management features are considered with the grantor trust rule.

My legislation makes clear that all classes of passthrough securities representing an interest in the same pool of assets must be issued simultaneously, and the interests represented thereby may not be changed after issuance. This does not, however, prevent the passing through of any adjustments inherent in the assets themselves, such as an adjustable interest rate or a prepayment of principal. Furthermore, the pool of assets must be fixed prior to the date of the first payment to security holders, except for a 2-year period in which substitution of substantially similar assets is allowed in connection with a breach of a representation or warranty made by the transfer of the assets to the trust. I believe that these restrictions provide protection against any tax deferral securities being issued under this provision and that the IRS has sufficient regulatory authority to handle such matters.

The bill contemplates that passthrough securities may be issued in one or more classes. A class is defined to include one or more classes. A class is defined to include one or more passthrough securities, each of which represents a pro rata right to specified cash payments and other rights provided for in the identified assets. For example, a class may represent an undivided interest in all of the assets of the trust; an undivided interest that differs from another class of undivided interests in that its right to payments on the assets is senior to or subordinate to such other class in the event of a delinquency or default on an underlying asset; or a sequential—"fast pay" or "slow pay"—interest which receives payments of principal—or similar amounts—on the assets prior to or later than another such interest, together with amounts designated as interest.

The assets which may be owned through a grantor trust are as proposed in the bill described as "financial instruments." These are defined to include: First, any evidence of indebtedness, such as residential or commercial mortgage, automobile loan, commercial bank loan, credit card receivable, or trade receivable; second, any lease receivable; third, any proceeds of a financial instrument, temporary investments of such proceeds and any income thereon, and any property acquired pursuant to foreclosure—or similar realization on a security interest—with respect to any financial instrument; and fourth, any other passthrough security. Proceeds of a financial instrument include any payment thereon or any payment in lieu thereof, such as advances, guaranty payments, insurance proceeds, or foreclosure proceeds. The bill would be effective with respect to passthrough securities issued after April 27, 1984, the effective date of proposed Treasury regulation section 301.7701-4.

The multiclass format has historically been used predominantly for mortgages. However, the securitization of nonmortgage assets, a relatively recent development, was not consciously excluded from early efforts to facilitate the securitization of mortgages. It simply was not in existence.

It would be incongruent to divide the capital markets by permitting one form of assets, mortgages, to be securitized versus other types of assets. Although homeownership is an important goal for many Americans, food, clothing, home furnishing, automobiles, and other consumer items are generally viewed as equally essential necessities. I believe that there is merit to including consumer loans, commercial mortgages, leases and other assets because this could have a substantially beneficial impact on consumers, business, and financial institutions. This is an area that deserves greater attention by the Congress and the Treasury.

For instance, finance companies, thrifts, and commercial banks that are holders of consumer loans will have a format to sell those loans and remove some of the risk inherent in consumer lending, such as student and education loans. Creating a more efficient capital market is one way to lower interest rates on credit card loans in response to continued consumer complaints that credit card interest rates are too high. Second, the securitization of commercial leases will be beneficial to computer companies as a means to raising capital for expansion by securitization of their equipment leases. Commercial banks for example, should benefit by being able to securitize and sell commercial loans and commercial real estate loans to investors more economically. This should add liquidity and new sources of fee income for these institutions. Mortgage bankers who are unable to withstand increased debt burdens on their balance sheets should benefit greatly from obtaining sale-of-asset treatment for securitization of commercial and residential mortgages. Thrifts, which in recent years have been the hardest hit by the high cost of financing their assets, should benefit greatly as well by having a new asset-liability management tool. This legislation will also provide them new sources of fee income and it will mitigate against loan losses on commercial and consumer loans as they diversify into these new lending areas. Domestic automobile companies have found in recent years that less costly financing alternatives offered by their finance company subsidiaries have been largely responsible for increased purchases of automobiles and have helped revitalize the automobile industry. The inclusion of automobile receivables as qualifying assets will help them substantially. It is also my belief that asset-based passthrough financings will be of substantial benefit to many other companies that are highly leveraged and/or cannot support additional debt burdens on their balance sheets. Indeed, several prominent financial commentators have argued that excessive debt burdens are endangering American corporations. This security can be used to provide asset liability management and improve the ratio of equity to debits of many corporations. Additionally, those Government sponsored agencies that sell mortgages such as Ginnie Mae, Fannie Mae, and Freddie Mac, will certainly benefit from the multiclass mortgage backed passthrough structure as it will lower their cost of funds.

Not to allow the use of a multiclass grantor trust for nonmortgage loans or assets will deprive consumers of the benefits of a more efficient security while creating yet another level of complexity by requiring regulators and investors to treat otherwise very similar assets differently. To not clarify the application of the Internal Revenue Code to the fullest extent possible is counterproductive to the overall tax simplification efforts presently being undertaken by the Congress and administration. While it is clear that the Treasury could proceed with authorizing a multiclass mortgage-backed passthrough, this is too important an area with broad public policy implications to be left solely to the Treasury.

This area has been in limbo since the proposed Treasury regulations were issued in early 1984. These regulations have never been made final. It is recognized that any change in the way business is done could have tax implications. However, because the Treasury has not spoken on these matters, the market has created other instruments such as the collateralized mortgage obligations to carry out this activity. This particular mechanism is an inefficient one and therefore a more costly one. If there are tax problems created by these instruments, it is time that Treasury stepped forward to propose a solution so that business in this important area of the capital markets can go on in an orderly manner.

The secondary market is now a large market with broad-based participation. Private entities such as General Motors Acceptance Corp., the General

Electric Credit Corp., Ford Motor Credit Corp., and Chrysler Financial Corp., are now all active participants in the secondary market. The growth of this market is being restrained by anachronistic tax laws and in some cases the application of laws that have no relevance to market activity. Now is the time for the Congress to begin the process of providing a unified framework for the future development and growth of the mortgage and asset-backed securities market to the benefit of consumers, underwriters, and issuers, both private and public. I would urge the chairman of the Senate Finance Committee to schedule hearings on this matter as soon as possible early next year. Mr. President, I ask unanimous consent to include in the RECORD the text of the bill and a technical explanation of the bill.

There being no objection, the material was ordered to be printed in the RECORD, as follows:

S. 1978

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the Recovery Act for Mortgage and Other Asset-Backed Securities.

SEC. 2. MULTI-CLASS PASS-THROUGH SECURITIES.

Subpart E of Part 1 of Subchapter J of Chapter 1 of Subtitle A of the Internal Revenue Code of 1954 (relating to the treatment of grantor trusts) is amended by adding at the end thereof the following new section.

"SEC. 680. PASS-THROUGH SECURITIES.

"(a) GENERAL RULE.—Holders of pass-through securities that represent interests in cash payments and other contractual rights provided for in identified financial instruments shall be treated for all purposes of this subtitle as the owners of beneficial interests in such payments and contractual rights, and the arrangement pursuant to which such financial instruments are held and such pass-through securities are issued shall be treated as a grantor, trust subject to the provisions of this subpart, provided that—

"(1) the interests in the financial instruments represented by the pass-through securities are established prior to the intitial issuance of the pass-through securities and, pursuant to the terms of the pass-through securities, such interests may not be changed, and

"(2) the financial instruments in which the holders of pass-through securities own interests are identified prior to the first payment made to holders and are not changed thereafter, except that substantially similar financial instruments may be substituted for identified financial instruments within 2 years of such first payment date in connection with a breach of a representation or warrenty made by the seller of all or a portion of the identified financial instruments.

"(b) CLASSES OF INTEREST.—One or more classes of interests in identified financial instruments represented by pass-through securities may be established with respect to the same identified financial instruments, and the arrangement pursuant to which such financial instruments are held and such pass-through securities are issued shall be treated as the same grantor trust.

"(c) BENEFICIAL OWNERSHIP OF FINANCIAL INSTRUMENTS.—Pass-through securities shall represent the ownership of beneficial interests in the underlying identified financial instruments to the extent of the holder's adjusted basis in such pass-through securities allocable thereto for all purposes of this subtitle, including section 593(d), section 851(b)(4), section 856(c)(5), and section 7701(a)(19)(C).

"(d) DEFINITIONS.—For purposes of this section—

"(1) PASS-THROUGH SECURITY.—The term "pass-through security" means—

"(A) an instrument that evidences the holder's contractual right to receive cash payments on identified financial instruments, the holder's rights in any security for such payments, and the holder's rights in other contractual rights contained in or incident to the identified financial instruments, where the issuance of pass-through securities representing interests in such financial instruments is treated as a sale under section 1001 of all or a portion of such financial instruments, and

"(B) the retained beneficial interest of the seller of a portion of such financial instruments.

"(2) CLASS.—The term "class" means a pro rata right to specified cash payments and other contractual rights provided for in identified financial instruments represented by one or more pass-through securities, which pro rata right differs from the right represented by one or more other pass-through securities, if any, established with respect to the same identified financial instruments.

"(3) FINANCIAL INSTRUMENT.—The term financial instrument means—

"(A) any bond, debenture, note, certificate, account receivable, or other evidence of indebtedness, or a participation interest therein;

"(B) any lease receivable;

"(C) any proceeds of a financial instrument temporary investments of such proceeds and any income thereon, and any property acquired due to a default on any financial instrument and any income thereon; and

"(D) any pass-through security representing direct or indirect interests in financial instruments described in subparagraph (A), (B), or (C)."

SEC. 3. EFFECTIVE DATE.

The amendments made by section 2 shall apply to pass-through securities issued after April 27, 1984.

TECHNICAL EXPLANATION OF THE BILL

The proposal provides that arrangements for the issuance of "pass-through securities" in one or more "classes" would be taxed as grantor trusts and not as corporations. As in the case of present mortgage pass-through securities, the holder of the security would be treated as the owner of his share of the assets represented by the security. The holder would be taxed on his proportionate share of the payments on the assets to the extent such payments represented either an undivided interest in the income on such assets or income reportable under the stripped bond rules of section 1286 or similar rules.

The proposal limits the proposed tax treatment to passive arrangements that do not carry on a business activity. Accordingly, all classes of pass-through securities representing interests in the same pool of assets must be issued simultaneously, and the interests represented thereby may not be changed after issuance, pursuant to the terms of the security. This does not, however, prevent the pass-through of any adjustments inherent in the assets themselves, such as an adjustable interest rate or a prepayment of principal. Furthermore, the pool of assets must be fixed prior to the date of the first payment to security holders, except for a two-year period in which substitution of substantially similar assets is allowed in connection with a breach of a representation or warranty made by the transferor of the assets to the trust.

As defined in the proposal, pass-through securities represent interests in assets that are treated as having been sold either in whole or in part by the transferor of the assets. Partial sales include transfers in which the transferor retains either an undivided interest in the assets or an interest consisting of one or more stripped coupons or stripped bonds within the meaning of section 1286 of the Code (or similar interests in the case of assets other than debt obligations). The beneficial interest retained by the transferor is also treated as a pass-through security. Essentially, any arrangement other than one treated for federal income tax purposes as an issuance of debt obligations by the transferor is included.

The proposal contemplates that pass-through securities may be issued in one or more classes. A class is defined to include one or more pass-through securities, each of which represents a pro rata right to specified cash payments and other rights provided for in the identified assets, which pro rata right differs from the right represented by one or more other pass-through securities, if any, established with respect to the same identified assets. For example, a class may represent an undivided interest in all of the assets of the trust; an undivided interest that differs from another class of undivided interests in that its right to payments on the assets is senior to or subordinate to such other class in the event of a delinquency or default on an underlying asset; or a sequential ("fast pay" or "slow pay") interest which receives payments of principal (or similar amounts) on the assets prior to or later than another such interest, together with amounts designated as interest.

The assets which may be owned through a grantor trust are described as "financial instruments" in the bill. These are defined to include (i) any evidence of indebtedness, such as a residential or commercial mortgage, automobile loan, commercial bank loan, credit card receivable, or trade receivable, (ii) any lease receivable, (iii) any proceeds of a financial instrument, temporary investments of such proceeds and any income thereon, and any property acquired pursuant to foreclosure (or similar realization on a security interest) with respect to any financial instrument, and (iv) any other pass-though security. Proceeds of a financial instrument include any payment thereon or any payment in lieu thereof, such as advances, guaranty payments, insurance proceeds, or foreclosure proceeds.

The Act would be effective with respect to pass-through securities issued after April 27, 1984, the effective date of Proposed Treasury Regulation §301.7701-4(c).

Mr. D'AMATO. Mr. President, today my colleagues and I are introducing legislation to help foster the growth of the mortgage-backed securities market and the development of a new market in asset-backed securities, including security interests in commercial real estate, equipment leases, credit card receivables, commercial loans, and automobile receivables.

Although I endorse this legislation, I realize that it may not provide a perfect solution. To the extent that the issues regarding phantom profits, original issue discount and revenue neutrality are not adequately addressed by the legislation in its present form. I fully intend that these issues by resolved during consideration of this bill. My qualified endorsement of the bill does not diminish my desire to compel the Treasury Department to clarify existing rules or promulgate new ones regarding the tax treatment of these securities. My colleagues and I have been prompted by Treasury's inaction in this area. This legislation therefore should be a starting point which will hopefully culminate in the passage of legislation or the promulgation of rules that sets forth a rational system of allocating taxes on these securities.

The efforts of our colleague Senator CHAFEE, who has also attempted to address this very complex issue in legislation introduced yesterday, deserve considerable credit. Although that legislation and the bill we introduce today address the taxation of certain securities, they represent slightly different approaches. The most significant distinction between the bills is that Senator CHAFEE's bill applies only to pools backed by mortgage backed securities while the bill that I am cosponsoring would clarify the tax rules as they would apply to many types of asset based securities. Senator CHAFEE's bill may also allow for an election procedure for debt treatment or asset treatment which would affect the taxation of the issuer. The legislation that I am cosponsoring does not change the character of the present multiclass passthrough securities but clarifies the tax treatment of these particular instruments. I am hopeful that we can work with Senator CHAFEE to inspire the Treasury to participate in the process and clarify tax treatment of the securities at issue. These legislative proposals are subject to modification due to the complexity of these issues and I hope that Treasury will finally come forward to address these very important issues.

This legislation would authorize the use of multiple classes of ownership in fixed investment or grantor trusts which are used in issuing passthrough securities. The legislation will harness the innovation of Wall Street to lower the cost of mortgage and consumer credit. These new innovations in the capital markets would provide additonal billions of dollars of credit to these markets and help commerical bankers, thrifts, mortgage bankers, finance companies, computer companies, and others to reduce the cost of financing their assets. This should allow them to reduce interest rates on loans they make to consumers.

Such legislation is a logical next step in the development of the mortgage-backed securities market following on the administration's trusts for investment in mortgages [TIMS] initiative and the recent enactment and signing by the President of the Secondary Mortgage Market Enhancement Act of 1984. This legislation recognizes, however, that other new assets are now a key part of the Nation's capital markets, especially the secondary markets.

The Recovery Act for Mortgage and Other Asset-Backed Securities is a response to the efforts of securities firms that have devised a marketing device that was utilized by them on certain mortgage-backed bonds, called collateralized mortgage obligations. Subsequently these firms attempted to apply this marketing structure to passthrough securities. The Treasury Department, however, on May 2, 1984, proposed restrictive amendments to its regulations on classification of investment arrangements with multiple classes of ownership. This legislation would help the Treasury distinguish the use of multiple class passthrough securities from restrictions proposed by Treasury on other investment arrangements where the Treasury was concerned about tax deferral or tax avoidance use of trusts with multiple classes of ownership.

During hearings held by the Treasury Department's Internal Revenue Service on its proposed regulations in this area, the Mortgage Bankers Association of America, the Public Securities Association, the National Association of Home Builders, and others testified and supported the concepts we have embodied in this legislation.

This legislation is intended to be revenue neutral and would merely eliminate roadblocks to more efficient capital markets. I believe this legislation will benefit consumers by causing interest rates to decline, assist in the continued recovery of the housing industry, and provide additional liquidity and efficiency in the lending operations of any other lender who securitizes assets. I therefore urge my colleagues to support our efforts to work with the Treasury on an issue of vital importance to investors, lenders, borrowers, and consumers.

I ask that my statement be included in the RECORD as if given.

Manufactured Housing Institute
1745 Jefferson Davis Highway, Arlington, Virginia 22202/ (703)979-6620

February 12, 1986

The Honorable Jake Garn
United States Senate
Washington, DC 20510

Dear Senator Garn:

We are pleased to respond to your letters of January 28 and February 6 inviting us to submit comments for the hearing record, on H.R. 3838, The Tax Reform Act of 1985.

The Manufactured Housing Institute

The Manufactured Housing Institute (MHI) is the national trade association representing builders of manufactured homes. There are about 170 companies producing homes in over 400 factories across the United States. About one-third of those companies are members of MHI. These manufacturers, however, account for about two-thirds of all manufactured homes produced annually in the U.S. MHI members also include 225 companies that supply a wide variety of goods and services to producers and consumers of manufactured housing. Our comments also reflect the views of the Coordinating Council for Manufactured Housing Finance which has previously communicated directly to tax writing committees on a number of provisions in H.R. 3838.

The Coordinating Council is an umbrella group, which has represented the manufactured housing industry on finance issues here in Washington. The Coordinating Council consists of the Manufactured Housing Institute and the National Manufactured Housing Federation, representing approximately 44 state and regional manufactured housing associations (consisting of retailers, rental community operators, manufacturers and lenders).

It is most appropriate that the Senate Banking Committee examine the potential impact of tax reform on housing, particularly in light of the Administration's efforts to reduce costly direct housing assistance programs.

Tax policy is of major importance to those who construct housing, to those who finance housing, and, thus, to those who reside in housing. We need a consistent tax policy that maintains our national commitment to affordable housing both for home ownership and for rental housing. A consistent policy of support for decent housing and home ownership has been a national commitment for more than fifty years. This principle should be a priority in any tax policy.

Furthermore, if the Congress wishes to make major changes in tax policy as H.R. 3838 proposes to do, we would urge that consideration be given to manufactured housing which has and continues to be an important source of affordable housing for many Americans.

Manufactured homes serve as the primary residence for over 12 million Americans, in particular, low to moderate income families, first time home buyers, and the elderly. Manufactured homes (commonly referred to as "mobile homes") are a vital source of affordable housing, especially in our nation's non-metropolitan, rural and outlying areas. The cost of the average new manufactured home is approximately $21,500 - $24,000, compared to the average site-built home cost of $90,000.

Over a million manufactured homes have been sold in the last five years; this is more than one out of five of every new home purchased.

Because most manufactured homes are usually purchased through a retailer, and financed as "personal property," they do not fit neatly into many real estate oriented housing finance and tax laws. (Although once purchased and placed on site, a manufactured home may be considered real estate under local laws.) Typically, owners of manufactured homes who do not own land reside in a rental community or manufactured home "park" and lease an individual lot from the park owner.

The manufactured housing industry has worked for the past several years with the Congress and Federal agencies in an effort to provide parity for manufactured housing with traditional "real estate" housing under federal law. Obtaining parity in finance and tax laws has often required specific treatment of manufactured homes and manufactured home rental parks, due to their unique legal or property status and different methods of finance, sale, and development.

As you evaluate the housing-related tax reform proposals now under consideration by Congress, we ask that you consider the possible impact of these changes upon the sale and financing of manufactured homes, particularly manufactured homes that are financed as personal property, and on the development and financing of manufactured home rental parks. MHI and the Coordinating Council will be happy to answer any questions you may have regarding manufactured housing, particularly as it relates to the tax proposals you are considering.

MHI and the Coordinating Council are currently monitoring legislative activities in the following tax areas, where the tax treatment of manufactured housing may have a substantial impact upon the industry.

Federal Tax Deductions of State and Local Taxes

The House bill retains full deductability of state and local taxes. We urge the Senate bill to do likewise. At a minimum, however, we urge the Senate to maintain the full deduction for both real property and personal property manufactured housing. Next to the mortgage interest deduction, the deduction of real property taxes is a key factor in making homeownership available.

As noted above, however, not all homes are necessarily classified or taxed as real property. In many states manufactured housing is classified and taxed as personal property. Although the amount of personal property taxes may not seem a significant burden as compared to real property taxes, they, in fact, may well be a real burden to the typical manufactured home owners, who generally are low- to moderate-income families. And, these families certainly deserve equal treatment under the law.

Not only would a proposed provision to eliminate the deduction of personal property taxes discriminate against manufactured housing as compared to traditional site-built housing, but it would also discriminate against manufactured home owners living in a state that taxes their home as personal property as compared to other manufactured home owners, with the identical home, who live in a state that taxes manufactured homes as real property. One homeowner's taxes would be deductible, while the other's would not. We trust that you would agree that this is not a fair or desirable outcome.

Therefore, we respectfully urge that the current language on H.R. 3838 regarding full deductability of state and local taxes be retained. At a minimum, we urge that at least all homeowner taxes, whether the home be taxed as real or personal property, be eligible for the proposed deduction. It is our understanding, as can be seen from the attached chart, that the revenue impact from broadening the proposed deduction to include personal property taxes--at least to the extent that they constitute homeowner taxes--would be insignificant.

Bad Debt Reserves

The bad debt reserves for thrift institutions--which under current law can equal up to 40 percent of taxable income, regardless of actual loan loss experience (it is based on a percentage of principal balance)--would be retained, but the benefits to thrift institutions would be drastically reduced. The maximum deduction would be reduced from 40 percent of taxable income to only five percent.

Current law (IRC S593) excludes manufactured homes not permanently affixed to real estate. A large percentage of manufactured homes are located in rental parks and might not meet this requirement. We seek parity with other types of housing. Should the Senate decide to retain the special benefits accorded to thrift institutions by IRC S593, parity should be provided for manufactured housing by making eligible for the deduction all residential manufactured homes whether or not permanently affixed to real property and whether or not titled and or taxed as real or personal property.

Installment Sales Treatment for Builder Bonds

Congress should preserve the option of installment sales treatment under IRC S453 where a home (site-built or manufactured) purchase loan is pledged as collateral for a borrowing. Installment sales treatment (so-called "Builder Bond" financing) is an important tool for raising capital for financing manufactured homes (whether real or personal property) as well as site-built homes.

Depreciation

Generally, we support the provisions in H.R. 3838 regarding depreciation. Provisions for manufactured homes treated as personal property continue to provide investment incentives to spur private investment in low income housing.

Mortgage Revenue Bonds

The bill would place new limitations on mortgage revenue bonds, as well as subject them to a much stricter volume cap.

The industry has taken limited advantage of mortgage revenue bonds largely because personal property manufactured homes are not currently eligible. To the extent that the Senate continues the mortgage revenue bond programs, manufactured housing treated as _personal_ property should be included. This would certainly be consistent with efforts to target the program to lower-income persons.

More recently, the manufactured housing industry has successfully used the _mortgage credit certificate_ (mcc) _program_. We strongly support the continuation of this important program for low-to-moderate-income homebuyers. MCC's are a cost-effective and efficient way of assisting home buyers otherwise unable to obtain mortgage credit.

Tax Incentives for Low-Income Housing

MHI is concerned that any tax reform legislation take into consideration the need to continue to produce low-income housing, including manufactured housing. We, therefore, would urge the Senate to consider the above recommendations which would treat manufactured housing on parity with the rest of housing and further consider supporting additional provisions that would encourage the investment in, and the development of, low income housing.

As currently drafted, the bill is viewed as creating a number of disincentives to tax shelter investments--including manufactured home rental communities. The key offending provisions are the less favorable depreciation rules outlines above, the limitations on the deductibility of investment interest, the application (in certain circumstances) of the at risk rules to real estate investments, and perhaps most important, the new stiff minimum tax rules. Hence, these provisions should be considered carefully in the context of creating incentives for the development of low income housing.

Effective Dates

We also are very concerned about effective dates. Most of the provisions of H.R. 3838 would take effect on January 1, 1986, with "grandfather" relief for certain projects underway as of September 25, 1985. Because it is not clear when tax reform legislation will be enacted, we are concerned that the effective dates in the House bill will cause serious disruption in the marketplace and have an adverse impact on investment decisions during 1986. Thus, we urge that the effective date of any final tax reform legislation be no earlier than January 1, 1987, with appropriate "grandfather" rules for projects underway prior to the end of 1986.

In closing, Mr. Chairman, we appreciate the opportunity to comment and please let us know if we can provide any further information.

Sincerely,

Jerry C. Connors
President

Attachment

JCC/S:ect

Table [illegible]

GROSS FEDERAL TAX SAVINGS FROM DEDUCTIBILITY OF SELECTED TAXES,
PER RETURN, BY STATE, 1982 a/

State	Income Taxes	General Sales Taxes	Real Estate Taxes	General Sales Taxes on Motor Vehicles	Personal Property Taxes
	Gross Federal Tax Savings Per Return				
Alabama	$249	$132	$ 60	$ 10	$ 8
Alaska	9	58	206	2	6
Arizona	232	105	109	26	20
Arkansas	310	65	91	19	13
California	583	132	200	36	28
Colorado	255	96	188	20	12
Connecticut	190	146	662	42	28
Delaware	739	9	153	2	1
Dist. of Columbia	808	101	266	37	1
Florida	67	96	258	29	5
Georgia	660	97	196	21	15
Hawaii	534	127	138	17	0
Idaho	343	60	135	11	1
Illinois	292	132	308	29	0
Indiana	206	81	125	29	18
Iowa	328	61	197	16	13
Kansas	295	79	159	18	42
Kentucky	330	80	112	21	12
Louisiana	126	140	63	30	1
Maine	558	83	332	28	19
Maryland	611	88	255	27	1
Massachusetts	592	68	603	26	10
Michigan	662	86	411	23	1
Minnesota	609	75	196	23	8
Mississippi	229	141	88	20	28
Missouri	281	101	146	20	14
Montana	275	11	201	6	7
Nebraska	279	85	212	20	19
Nevada	36	100	120	48	13
New Hampshire	186	10	686	3	16
New Jersey	426	96	505	28	1
New Mexico	114	103	90	14	2
New York	831	154	345	21	1
North Carolina	473	90	138	6	5
North Dakota	106	69	222	29	1
Ohio	604	104	198	29	28
Oklahoma	364	96	98	17	21
Oregon	523	3	236	1	0
Pennsylvania	401	78	268	29	11
Rhode Island	632	98	366	43	26
South Carolina	617	91	104	22	14
South Dakota	9	99	164	25	0
Tennessee	36	164	175	28	1
Texas	12	105	249	32	3
Utah	299	103	145	21	9
Vermont	309	38	236	13	0
Virginia	666	98	229	18	31
Washington	17	160	199	28	15
West Virginia	394	97	82	24	8
Wisconsin	573	88	330	15	0
Wyoming	28	103	83	32	13
U.S. Average	$411	$106	$247	$25	$11
Minimum	$9	$3	$63	$1	$0
Maximum	831	164	505	48	42

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a/ The breakdown of tax savings by state is subject to two sources of error. Because the tax savings is allocated to the state of address on taxpayers' returns: 1) to the extent that taxpayers pay taxes in more than one state, not all of the tax savings are allocated to the right state and 2) to the extent the address on taxpayer returns differed from their home state, the accuracy of the data was affected. This explains why Texans, for example, are shown to derive some tax savings from the income tax deduction even though Texas does not levy an income tax.

Source: ACIR staff calculations based on Office of Tax Analysis, Office of the Secretary of the Treasury, "Tabulations from the 1982 Statistics of Income File for the Fiscal Relations Study," December 14, 1982, Tables 2 and 6 and Internal Revenue Service, Statistics of Income--1982, Individual Income Tax Returns, Washington, D.C., U.S. Government Printing Office, 1984, Publication 79(10-84), Table C, p. 11.

TESTIMONY OF MINTZ, LEVIN, COHN, FERRIS, GLOVSKY and POPEO, P.C. BEFORE THE U.S. SENATE COMMITTEE ON BANKING, HOUSING & URBAN AFFAIRS

We appreciate the invitation extended by the Committee to this firm and others to address the potentially devastating impact of H.R. 3838, as passed by the House of Representatives, on the ability of state and local governments to perform their time-honored role of providing affordable basic services and facilities to the public.

As bond counsel to numerous state and local entities, including the Commonwealth of Massachusetts, the City of Boston, and a variety of government agencies and authorities, Mintz, Levin has struggled along with its clients with a tax code that has become increasingly hostile to the primary financing tool available to states and localities, tax-exempt municipal securities. Three times in the past five years the federal tax provisions regulating state and local debt obligations have been amended in a manner restricting states and their political subdivisions from borrowing money needed for public purposes and materially complicating the borrowing process. These previous amendments now appear almost trivial, however, when compared to the destructive impact that would result from the enactment of H.R. 3838 in its current form. Furthermore, this threat to the borrowing capacity of state and local governments comes at a time when their financial resources are being diminished on various fronts.

The restrictions imposed on tax-exempt financing by H.R. 3838 are ill-conceived, unnecessary, and counter-productive, and will inflict societal costs disproportionate to any benefit they may achieve. Unfortunately, because of their complex and technical nature, as well as their inclusion in a bill overhauling numerous other features of our tax laws, there is a danger that the meaning and effect of the restrictions on municipal financing will elude legislative scrutiny.

Perhaps the most graphic illustration of the flawed nature of H.R. 3838 as it affects municipal financing is its terminology. The bill creates a new category of bonds called "non-essential function" bonds which, unless deemed "qualified," may not be issued on a tax-exempt basis at all, and, even if "qualified," are subject to severely inadequate volume caps and to highly burdensome administrative requirements. A "non-essential function" bond is defined as any state or local government obligation more than 10% (or $10 million) of the proceeds of which is used by nongovernmental persons or more than 5% (or $5 million) of the proceeds of which is loaned to nongovernmental persons. Swept into this "non-essential" category are bonds used to finance hospitals, multifamily housing, sewage disposal facilities, solid waste and resource recovery facilities, mass commuting facilities and water supply systems, airports, student loans and educational facilities.

Because the financing of projects labeled "non-essential" will at worst be impossible or impracticable, and at best be far more costly than it would be absent the restrictions imposed by H.R. 3838, two questions must be asked and answered. First, by what authority has the House of Representatives usurped the right to determine which functions of state and local governments are "essential" and which are "non-essential"? Second, is there not something misguided about a tax "reform" bill which incorporates the premise that meeting the public's need for health care, housing, education, transportation and a clean environment is a "non-essential" function of government?

As H.R. 3838's own terminology indicates, a vote in favor of the bill's cut-backs on tax-exempt financing is a vote for a radically redefined system in which the federal government limits, if not eliminates, the ability of states, cities and towns to finance at affordable rates projects that, prior to H.R. 3838, have constituted a major part of the core facilities and services a government provides its citizens. H.R. 3838 achieves this startling result by prohibiting tax-exempt financing in some instances and by increasing the cost of every type of tax-exempt financing it theoretically preserves.

The bill cuts off entirely access to tax-exempt financing for projects involving parking facilities, pollution control, sports facilities, convention centers, and certain port storage and electricity-furnishing facilities. Other projects will benefit from tax-exempt financing only if they receive an allocation out of the state-by-state volume cap established by H.R. 3838. Under current law, only mortgage subsidy bonds, student loan bonds and industrial development bonds are subject to volume restrictions. Under H.R. 3838, all "non-essential function" projects would be subject to a state volume cap in the amount of the greater of $175 per capita or $200,000,000, which cap would be reduced in 1987 to the greater of $125 per capita or $200,000,000.

Had this volume cap applied previously, over $5 billion of public purpose projects in 1984, and over $47.6 billion in 1985, would have been deprived of tax-exempt financing. The negative effect of the cap will vary by state and by type of project. Over 57% of the tax-exempt projects undertaken in Florida in 1984 no longer would be eligible under H.R. 3838; equally precipitous reductions from 1984 levels would occur in other states, such as Alaska (48%), California (42%), Colorado (29%), Louisiana (28%), Massachusetts (22%), Minnesota (30%), North Dakota (38%), Nebraska (27%), New Jersey (16%), Nevada (46%), Pennsylvania (28%), Rhode Island (64%), South Dakota

(30%), Texas (38%), Utah (45%) and Virginia (28%). The corresponding percentage of 1985 projects that would not have obtained tax-exempt financing is even higher.

The cost of taxable borrowing historically has been approximately 30% higher than that of comparable-term tax-exempt debt. Thus, the likelihood is that the vast majority of projects shut off from tax-exempt financing by H.R. 3838, either because they fall into a prohibited category or because they fail to obtain an allocation under the new volume cap, will be priced out of the reach of many state and local communities.

Less obvious, but no less threatening to the underpinnings of state and local government, is the effect of the proposed revisions on those forms of tax-exempt financing that survive under H.R. 3838. The bill's provisions make municipal securities much less attractive to investors and much more expensive and inconvenient to issuers. The inevitable result is that the costs of _all_ state and local financings will spiral upward.

The most pernicious of the new restrictions is the extension of a number of technical rules previously confined to industrial development bonds to all government debt instruments, including general obligation bonds issued to finance schools, roads and other facilities conceded even by the House to be "essential functions" of government. State and local entities traditionally have increased available monies for their public purposes by investing bond proceeds prior to use at an interest rate higher than that being paid to bondholders (this "spread" is referred to as "positive arbitrage"). The bill requires, with certain minor exceptions, that all such positive arbitrage be rebated to the United States Treasury. Notwithstanding this requirement, which effectively makes the federal government the sole beneficiary of positive arbitrage, the bill in addition requires state and local entities to yield-restrict their investments, except during certain poorly defined "temporary periods," so that no positive arbitrage will be earned. In addition to placing a straightjacket on state and local investment strategies, H.R. 3838 would eliminate state and local discretion as to the pace at which bond proceeds are expended. The bill requires in most instances that 5% of bond proceeds be spent within 30 days of issuance and that all bond proceeds be spent within three years of issuance. Most egregiously, the bill mandates that even an inadvertent violation of these complicated, duplicative, and in some cases unworkable restrictions will result in the loss of tax-exempt status retroactive to the date of issuance.

The unprecedented application of this morass of restrictions to all state and local issuers would impose at least three layers of additional cost on the use of municipal bonds as a financing tool. First, the rebate requirement, which in effect taxes at a 100% rate any profits by states or localities on the investment of bond proceeds, would terminate the ability of government issuers to rely on positive arbitrage as a means of defraying project costs. Because the federal government would reap all fruits of their investment strategy, state and local issuers would be forced to borrow higher amounts to finance their projects. Second, states and localities would have to shoulder the significant administrative costs of continually monitoring the yield on their investments and of putting in place a rebating mechanism. Third, the spectre of retroactive taxation of interest on municipal securities if an issuer is unable to comply with each of a host of difficult new requirements will undermine investor confidence in the tax-exempt status of such income. State and local governments would have to increase the interest rate on their obligations by an estimated one-half percentage point to compensate bondholders for this additional risk. This would require incremental expenditures of millions of dollars over the life of most bond issues.

These burdensome restrictions, as well as numerous other features of H.R. 3838--including provisions subjecting "non-essential function" bonds to an alternative minimum tax, restricting banks from deducting the interest cost of carrying tax-exempt portfolios, imposing a special minimum tax on tax-exempt securities owned by insurance companies and limiting the ability of issuers to take advantage of interest rate drops by refunding their obligations--are destined to weaken dramatically the marketability of municipal securities and to maximize the cost to states and localities of issuing such securities. The incremental borrowing expenses directly attributable to H.R. 3838 over the next five years would be on the order of $20 billion to $50 billion--far exceeding the estimated $3.8 billion in additional federal revenues the provisions are designed to raise over that period. Indeed, many of H.R. 3838's provisions--for example, the yield restriction requirements -- will drive up state and local costs without any benefit to the federal Treasury.

H.R. 3838 seeks to squeeze out of state and local governments at exorbitant cost modest additional revenues that will facilitate federal tax cuts included in the bill. The 1981 tax cuts and the ensuing deficits spawned the Gramm-Rudman Act. The tax cuts proposed in H.R. 3838 tread upon equally sacred constitutional principles to the extent they are premised on an unprecedented disregard for the constitutional standard of reciprocal tax-exemption between state and federal credit instrumentalities.

Even apart from principles of federalism, sound policy requires that H.R. 3838's revisions to the tax treatment of municipal obligations be rejected or substantially restructured. At a time when federal aid to states and localities is being decimated by budget cuts needed to cope with the deficits generated by the last round of tax cuts, logic dictates that states and localities be permitted to rely more heavily on tax-exempt borrowing to compensate for losses in federal grants and revenue-sharing. To instead cripple the states' borrowing capacity through additional restrictions would be not only unconscionable but self-destructive. The federal economy and state and local economies are not unrelated. Federal tax law that purports to encourage "capital formation" which at the same time stopping development of the nation's infrastructure of public facilities and services is senseless.

If the top bracket tax rate were lowered from 50% to 39%, instead of the 38% level suggested by the House, the misconceived provisions relating to municipal obligations incorporated in H.R. 3838 would be entirely unnecessary. We urge the members of the Committee to exercise their influence to preserve the current tax code's treatment of municipal obligations so that state and local governments may continue to fulfill their traditional, and essential, functions.

ROYER, SHACKNAI & MEHLE
ATTORNEYS AT LAW
[illegible] PENNSYLVANIA AVENUE, N.W.
WASHINGTON, D.C. 20006
[illegible]

[illegible]

OF COUNSEL
STANLEY [illegible]
[illegible] MADISON AVENUE
NEW YORK, NEW YORK [illegible]
[illegible]

February 20, 1986

The Honorable Alfonse M. D'Amato
Chairman
Subcommittee on Securities
Senate Committee on Banking, Housing,
and Urban Affairs
534 Dirksen Senate Office Bldg.
Washington, D. C. 20510

Dear Senator D'Amato:

In response to an inquiry by your staff regarding the impact of the effective date provisions of H.R. 3838 on the current state of tax-exempt financings, I am providing the following information.

Mr. Richard Franke had stated in his prepared testimony that H.R. 3838 had brought the market to a virtual standstill. In order to quantify that remark, we think it is appropriate to compare the activity in the first six weeks of 1985 and 1986. Year end figures are not as indicative of the actual market or any trend since any number of factors can cause a year end surge in volume. During the first six weeks in 1985, there were 432 issues totalling $11.297 billion. Of this volume, there were 192 general obligation issues totalling $3.539 billion and 240 revenue bond issues totalling $7.758 billion. The first six weeks of 1986 has produced only 98 issues totalling $3.365 billion. This volume represents 75 general obligation issues at $1.843 billion and 23 revenue bond issues at $1.522 billion. I think you will agree that the contrast is staggering.

As usual, please do not hesitate to contact me if further information is needed.

Very truly yours,

Robert S. Royer

Robert S. Royer

STATEMENT OF
RICHARD J. FRANKE, CHAIRMAN
MUNICIPAL FINANCE INDUSTRY ASSOCIATION

INTRODUCTION

Mr. Chairman, my name is Richard J. Franke. I am here today in my capacity as Chairman of the Municipal Finance Industry Association, a group of investment banking firms which provide financing services to municipalities throughout the nation for a wide variety of projects and which sponsor a variety of investment vehicles and services for lenders and investors. This group represents two-thirds of a $35 billion a year industry providing investors with diversified municipal bond investments through unit trusts and funds. In addition, I am President and Chief Executive Officer of John Nuveen & Co. Incorporated, a company that has specialized in municipal finance since its inception in 1898.

Title VII of H.R. 3838 (the "Bill") imposes far reaching changes to the tax-exempt bond provisions of the Internal Revenue Code, while section 57(a)(6) of the Bill takes the unprecedented step of including some municipal bond interest in the computation of the Alternative Minimum Tax (AMT) base. For a variety of reasons, which I shall discuss at length, these changes concern me greatly.

THE MUNICIPAL BOND MARKET

Public bodies in America have borrowed money since colonial times. The exercise of that power has been carefully controlled by legislators at all levels of government. The almost annual debate in Congress concerning the debt limit is but one manifestation of this process. Most states have taken a less flexible approach by including within their constitutions limitations on the ability of local units of government to incur debt. But most states, unlike the federal government, have allowed local units of government wide latitude to provide revenue bond financing for needed projects. The practice of municipal finance has varied widely, but has standardized considerably in this century as the debt markets have imposed on municipal borrowers procedural and financial disciplines designed to permit borrowers, large and small, sophisticated and otherwise, to access needed capital.

A key feature of this market for municipal debt is its diversity, encompassing some 50,000 municipal borrowings. Another key feature has been its autonomy from other debt markets. Municipal borrowers do not register their securities with the Securities and Exchange Commission. Although municipal securities are subject to the anti-fraud provisions of the

Securities Act, the responsibility for policing disclosure rests at the local level with attorneys, accountants, underwriters and finance officials who specialize in this market. When Congress brought municipal dealers under the Securities and Exchange Act in 1975, it made explicit that it was not asserting any jurisdiction over municipal issuers in recognition of the doctrine of reciprocal immunity established by the Constitution. We believe that the Bill represents a serious erosion of this constitutional principle, and in certain of its applications to municipal securities is probably unconstitutional.

A. Borrowers

States, counties, cities and other municipal entities represent a separate and parallel form of government oriented to providing local services not provided by the federal government. The range of these services is extraordinary, encompassing, to name a few, water and sewer systems, universities, schools, roads, and hospitals. Local governments undertake these services after detailed study and debate, careful planning, and close attention to costs. The municipal market provides a link between the local government process and the pools of private capital which finance that level of government. Because these services are paid for by the local population, cost is very important, affecting directly the taxes or user charges that will be required to support them.

Before the enactment of the federal income tax early in this century, debt markets for federal and local securities existed side-by-side with rate differentials reflecting the additional risk of local entities and the lower liquidity of local securities. Since the enactment of the Federal income tax, the interest paid by non-municipal borrowers is higher than that paid by municipal borrowers because the interest on municipal obligation is not subject to federal income tax. That is one of the prices that the nation pays for the federal/state system established by the Constitution.

H.R. 3838 proposes that the interest earned on certain municipal bonds be included as a preference item in the computation of the Alternative Minimum Tax base for both corporations and individuals. This requirement applies to specific types of bonds, discussed later, that finance some of the most necessary and expensive local services. Coming at the same time as a substantial reduction in the federal aid to local governments contemplated by current federal budget proposals, inclusion of interest as an AMT preference represents a severe blow to local government financing.

The municipal market experienced an unprecedented surge in volume during the last quarter of 1985. This surge was similar to smaller ones which occurred during the final quarters of 1984 and 1983. In all three years, it was proposed or prospective changes in the tax law which brought about the increase in volume. Abnormal volume raises the the interest rates which borrowers must pay. In the last quarter of 1985, taxable and tax-exempt rates converged to their closest proximity in history. Short-term tax-exempt rates actually exceeded short-term taxable rates for a brief period around the year-end. This, however, was an aberration brought on by the January 1, 1986 effective date in the Bill.

As a Chief Executive Officer, I am required to take a long view to the vitality of this market and its value for the clients and customers of our firm and industry. The passage of H.R. 3838 by the House of Representatives, with an almost immediate effective date and a complex web of new regulations, caused the chaos in the market late in 1985 and has since brought the market to virtual inactivity. H.R. 3838 has had the effect of law even though the legislative process is incomplete. It has brought the normal operation of the market to a standstill because of its retroactive effective dates.

Whatever the outcome of the Bill, it has to respect the broader federal/state system. Effective dates should be set to allow an orderly transition to the new legislative plan. Congress should not force billions of dollars of additional interest expense on local-units of government to achieve imperfectly quantified and doubtful revenue increases.

B. The Lenders

The investor market for municipal bonds consists of commercial banks, casualty insurance companies and individuals. Individual investors presently constitute the most important market segment for municipal bonds. Over the past decade, they have represented the largest single source of long-term capital for municipalities, through direct ownership of bonds and the purchase of municipal bond trusts and funds. More importantly, individuals have been suppliers of municipal capital during the cyclical downturns in demand for bonds in the other two market segments. Bond funds and trusts provide a very high level of security with good liquidity and a comparative absence of complexity, making municipal bond investment available to smaller investors in a convenient form.

Commercial banks historically represent approximately 30 percent of the investor market, and concentrate their buying on bonds with maturities of up to ten years. Since interest rates in this maturity range are lower than for longer maturity bonds, it is important to have bank buyers active in the market. Withdrawal by banks will make it more expensive for local borrowers to secure money, as happens from time to time during periods of tight credit when it is more difficult and expensive for localities to sell bonds.

Casualty insurance companies have historically been important, yet cyclical, purchasers of medium and long term municipal bonds. I emphasize the word cyclical because industry operating loss cycles regularly reduce the profit of the industry so dramatically that it becomes a net seller of municipals. Nonetheless, when the industry is in a healthy phase without excessive underwriting losses, it is an important source of capital for municipal borrowers.

Local governments have a strong motive to keep their three major sources of capital intact. The Bill undermines significantly the participation of all three investor groups in the municipal market by eliminating bank deduction of municipal bond carrying costs, by imposing a minimum tax on casualty insurance company municipal bond income, and by including some municipal bond interest as an AMT item for individual investors. This simultaneous attack on all three market participants will substantially raise borrowing costs for local governments at a time when direct federal assistance is declining. Additional financing costs at the local level will far exceed any additional revenue to the federal government.

SUMMARY OF PROPOSALS

Before I deal with some of the specific items of H.R. 3838, I'd like to provide a brief overview of a few key provisions. The Bill makes a significant distinction between projects that are entirely owned and operated by a governmental body, and those for which some mix of public/private ownership or use is contemplated. Interest on state and local government bonds issued to finance facilities that are entirely government owned and used continue to be tax-exempt. The Bill, however, creates a new category of bonds called nonessential function bonds for bonds or projects in which private involvement exceeds as little as five percent.

Interest on nonessential function bonds will be taxable unless a specific exception applies. Activities which qualify for tax-exempt status include (a) airports, docks and wharves, mass commuting facilities, certain water furnishing facilities, sewage and solid waste disposal facilities, and qualified multi-family residential rental projects; (b) qualified mortgage bonds and qualified veterans' mortgage bonds; (c) qualified small-issue bonds; (d) section 501(c)(3) organization bonds; (e) qualified student loan bonds (expanded to include certain bonds not issued in connection with Department of Education guarantees); and (f) qualified redevelopment bonds.

The Bill provides for a unified state volume limitation for all nonessential function bonds and the nongovernmental portion (in excess of $1 million) of other bonds.

The Bill extends to all tax-exempt bonds both a requirement that certain arbitrage profits be rebated to the federal government. The Bill also restricts or prohibits advance refundings of all tax-exempt bonds and restricts the early issuance of such bonds.

ANALYSIS OF H.R. 3838 AND ITS COMMITTEE REPORT

A. Introduction

According to the Committee Report on H.R. 3838, the House Ways and Means Committee

> ... is concerned that the large volume of nongovernmental tax-exempt bonds and the accompanying ability of higher income taxpayers to avoid paying income tax erodes confidence in the equity of the tax system, increases the cost of financing traditional government activities, and results in an inefficient allocation of new capital.

The Report goes on to say that the Committee wants to correct these problems without affecting the ability of state and local governments to raise funds for operations or government facilities. The Committee is certainly well intentioned in its concern about the state of local government finance, but in our close work with municipal finance directors, we hear a very different set of concerns.

The first concern we often hear relates to the desire of local officials to remove necessary services from the already burdened tax rolls, and shift the costs of these services more directly to the users of the facilities. This trend is exemplified by the use of revenue bond financing which has burgeoned in the past two decades as finance officials have sought to improve the equity of the local finance system. Because revenue bonds will be affected the most by the Bill, the trend will be reversed.

A second concern of municipal finance officials has to do with the effect of the Bill on creative public/private partnerships designed to lower costs of municipal projects by attracting private capital and expertise. Current law allows a modest proportion of a publicly financed facility to be used in conjunction with private parties. The Bill takes direct aim at such partnerships by categorizing bonds issued for them as nonessential function bonds, thereby increasing interest costs. Finance directors with whom we have spoken prefer the flexibility embodied in current law.

The Committee is correct in stating that volume increases the interest rate. That, however, is the way in which the private market allocates capital -- it puts a price on it. No one anywhere has ever found a more efficient way of allocating capital than price.

The Senate should be very reluctant to accept the premises of the Committee Report since they do not represent the consensus of the borrowers which the Committee intended to help. The Senate should also resist the imposition of administrative approaches to allocating municipal capital.

B. The Alternative Minimum Tax

Section 57(a)(6) of the Bill includes interest on non-essential function bonds as a preference item for computing the Alternative Minimum Tax (AMT). The Committee Report states generally that the minimum tax should serve "to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits." The latter are termed counterproductive "when taxpayers are allowed to use them to avoid virtually all tax liability."

The AMT is designed to reach the taxpayer who has combined real economic income with "passive activity losses," such as accelerated depreciation and interest expense in excess of the taxpayer's actual investment. Municipal bonds provide investors with income but generate absolutely no tax shelter. Current law effectively limits tax sheltering depreciation and investment tax credit in all situations financed with municipal bonds.

Investors do not use tax-exempt bonds to avoid tax liability. They invest after-tax dollars in a municipal instrument after examining the broad spectrum of fixed income investment alternatives which the free market offers. Municipal bonds are suitable investments for many taxpayers, with the added social bonus of financing public and quasi-public projects. By contrast, the taxpayer who uses tax preferences to reduce before-tax income to the point that the AMT becomes relevant is not a candidate for municipal bonds. If one has successfully sheltered his income, he will have reduced his tax bracket to a level that decreases the value of an investment in lower yielding tax-exempt bonds. The Senate should keep this critical distinction in focus.

The Committee Report states that income from nonessential function bonds "must be added to the minimum tax base if the minimum tax is to serve its intended purpose of requiring taxpayers with substantial economic income to pay some tax." This is a new rationale for the AMT, which the Senate should seriously question before embracing. This rationale ignores the lower rate of interest which this investor has accepted to make his loan to a local unit of government. This rationale is in direct conflict with the constitutional principle of reciprocal immunity.

The constitutionally suspect AMT inclusion is combined in the Bill with direct volume limitations. Please refer to the compilation of bonds no longer allowed in any form (e.g., pollution control), those which are severely curtailed (e.g., advance refunding), those which will end soon under sunset provisions (housing), and those which are subjected to arbitrary volume limitations. If that were not enough, taxpayers can avoid the AMT inclusion by avoiding the nonessential function bonds, which they surely will, driving the borrowing costs for issuers of such bonds up dramatically. The AMT inclusion coupled with direct volume limitations is surely overkill.

While the impact of section 57(a)(6) will be minimal with respect to increased Treasury revenues, the impact on the market place will be significant. Imposition of the new AMT rules will require municipal bond-holders to account separately for the income from nonessential function bonds. Bond fund sponsors will have to advise customers that investment earnings may have

AMT implications. This adds considerable uncertainty to the marketplace since investors will now have to concern themselves with what particular type of tax-exempt investment income they have and whether AMT will affect them at year end.

Our typical investor is one who should not have to concern himself with such matters. He is a smaller investor purchasing tax-exempt bonds with after-tax dollars as an alternative to other fixed income investments. He has chosen a fixed income investment for simplicity and certainty rather than for higher rates and tax shelter. AMT will unfairly stigmatize and complicate the market for this investment alternative, driving away the small investor who will no longer accept the low rate of interest coupled with the complicated accounting and tax reporting for AMT. Issuers cannot afford to lose the small individual investor. The inclusion of municipal interest as an item of AMT penalizes the municipal borrowers and not the taxpayer abusing tax shelters and deductions. It is the municipal borrower who will pay the AMT through higher borrowing costs.

C. Sec. 145. Volume

The Committee imposed a unified volume cap on nonessential bonds in order to control the total volume of such bonds. Unfortunately, the Committee's definition of "nonessential" for tax purposes may conflict with what a local government deems essential for some particular community service. Control is more properly left in the hands of state and local governments to ensure the most efficient provision of essential local needs.

I would like to focus your attention on an aspect of the non-essential function bond definition which I find particularly difficult to understand. I accept that one element in any analysis of whether the federal government can regulate the issuance of municipal bonds--which constitutional scholars will doubtless raise if the Bill is passed--is the nature of the federal interest which serves as a trigger for the Supremacy clause. Focus on hospitals and universities exempt from tax under section 501(c)(3) of the Internal Revenue Code. Except for VA hospitals and a few research facilities, there are no federal hospitals. Except for the military academies, there are no federal universities. The provision of these services has never been the function of the Federal government and has always been the responsibility of governments at the state and local level. Where need and the eleemosynary impulse have preceeded the provision of these services by local governments, these governments have acknowledged the provision of health care and education by charitable organizations with almost universal local tax exemption, land grants, and low cost capital in the form of municipal revenue bonds. The practice of non-federal governments has always been to recognize the essential, governmental function of nonprofit hospitals and universities. Yet, the Bill proposes to include bonds issued by these organizations in the nonessential function category subject to the volume limitations and the AMT.

D. Sec. 147. Arbitrage

Prudent finance practice dictates for all but the largest and best established borrowers that financing be locked in before a project begins. You don't start moving dirt until you know that you can pay for it. Current tax law recognizes this by providing borrowers with a three-year period in which the proceeds of borrowings can be invested pending staged disbursement during construction. This time frame is also in accord with many state laws that preclude the awarding of a municipal construction contract until after bond proceeds are in hand. Current law, however, further requires that investment earnings during this period be retained in the project, reducing the amount required to be financed. H.R. 3838 changes that. Municipalities would be required to rebate to the Treasury virtually all investment earnings, thereby increasing the amounts required to be borrowed.

The Committee Report states that arbitrage is an inefficient substitute for additional bond volume and can be more costly to the federal government than additional volume. There is no support for this assertion. In fact, the majority of municipal borrowers are relatively small units of government with limited financial staff. Experienced bond counsel advise me that, weighted by volume in the various market segments, the bill doubles or triples the legal overhead of the market. Municipal finance directors report that construction fund management will be much more laborious with detailed filings to the Treasury, and that costly accounting services will be required to comply.

Current arbitrage regulation has been developed carefully over the past decade by Congress and the Treasury Department with substantial input from the municipal industry. It is extremely complicated, but it works to eliminate virtually all perceived abuses. The Senate should be reluctant to scrap a workable system that has been assembled carefully over time. The new system was hastily assembled within the Bill and will impose monumental accounting and regulatory burdens on the borrowers.

E. Sec. 148(d). Advance Refundings

The Report states that the advance refunding restrictions are the result of the Committee's desire to control the volume of tax-exempt obligations and to eliminate economic inefficiencies. The Report is silent on the nature and extent of those inefficiencies and does not take into account Treasury revenues from refundings. For example there are significant savings to the

Treasury in billions of dollars of below-market-rate loans made by municipal borrowers to the federal government when they invest their refunding proceeds under current law.

Once again, the Bill substitutes an administrative approach for an economic one. It imposes arbitrary limitations on the number of times a borrower can refinance debt and dictates limitations on the structure of the refunding bonds. The fact is that most refundings are undertaken to save local governments interest and other costs.

Another aspect of this Administration approach is its insensitivity to changing economic conditions. Bond convenants appropriate for a small issuer are often different from those appropriate for a larger entity. Growth, as well as newly developed financing techniques, dictate that a typical prospering community make changes in its controlling bond documents. These changes can usually be made only by refunding outstanding bonds. The Bill would impede orderly and timely growth in community projects and services by unnecessary restrictions on advance refundings. The decision of a municipality to refund should be an economic decision made by the local community.

CONCLUSION

The tax-exempt bond market is a complex system designed to make pools of private investment capital available to achieve the purposes of local government. The Committee Report manifests a lack of comprehension of the market as a whole and reflects the narrow focus of the House Ways and Means Committee on raising revenues. The Bill erects an imposing new system of regulation that will dramatically raise overhead costs in the municipal market for the sake of doubtful revenue increases. The Bill and the manner in which it has been advanced demonstrate a stark disregard for the principle of comity embodied in the Constitution. The tax-exempt bond provisions have been imposed on the market by a nearly simultaneous effective date and without adequate opportunity for municipal industry comment. They currently have the force of law in the marketplace by virtue of the now retroactive effective date. The Senate has an opportunity to advance the good of the Republic as a whole by retaining current law and preserving the freedom of local governments to manage their financial affairs based on economic and market forces rather than arbitrary administrative rules and the inhibition of tax ability.

APPENDIX

THE DOCTRINE OF RECIPROCAL INTERGOVERNMENTAL TAX IMMUNITY

The doctrine of reciprocal intergovernmental tax immunity flows from traditional notions of federalism memorialized in our Constitution.

The United States Constitution was written with the express guarantee that the States are to retain all the attributes of sovereignty in certain areas.

The Tenth Amendment to the United States Constitution provides:

> The powers not delegated to the United States by the Constitution, nor prohibited by it to the states, are reserved to the states respectively, or to the people.
> U.S. CONST. amend. X.

The States possess a long-recognized implied constitutional power to borrow money for public purposes. In Pollack v. Farmers' Loan & Trust Company, 157 U.S. 429 (1895), the Court declared:

> ... under the fundamental law, as to the power to borrow money, neither the United States on the one hand, nor the states on the other, can

> interfere with that power as possessed by each and an essential element of the sovereignty of each. 157 U.S. at 585.

The power to borrow money free from federal regulation arises, then, from a state's status as a sovereign power, which status is inherent in the federal system established by the United States Constitution. See generally, Pollock v. Farmers' Loan & Trust Company.

Historically, interest on State obligations has not been taxed by the federal government. In Weston v. The City Council of Charleston, 27 U.S. (2 Pet.) 481 (1829), Chief Justice Marshall, speaking for a majority of the Court, held that the ordinance of the City of Charleston imposing a tax of "twenty-five cents upon every hundred dollars of ... six and seven per cent stock of the United States" was unconstitutional.

Chief Justice Marshall stated:

> If the right to impose the tax exists, it is a right which in its nature acknowledges no limits. It may be carried to any extent within the jurisdiction of the State and corporation which imposes it, which the will of each State and corporation may prescribe. 27 U.S. (2 Pet.) at 487.

In Pollack v. Farmers' Loan & Trust Company, the Court considered, among other questions, whether the income from State-issued securities could be taxed to the holder under the Revenue Act of 1894. Recognizing that previous case law forbade federal taxation of the property or revenues of a State, Chief Justice Fuller concluded:

> But we think the same want of power to tax the property or revenues from the states or their instrumentalities exists in relation to a tax on the income from their securities, and for the same reason, and that reason is given by Chief Justice Marshall in Weston v. Charleston, ... where he said: 'The right to tax the contract to any extent, when made, must operate on the power to borrow before it is exercised, and have a sensible influence on the contract. The extent of this influence depends on the will of a distinct government. To any extent, however inconsiderable, it is a burden on the operations of government. It may be carried to an extent which shall arrest them entirely ... the tax on government stock is thought by this court to be a tax on the contract, a tax on the power to borrow money

> on the credit of the United States, and consequently to be repugnant to the Constitution. 157 U.S. at 585.

This doctrine of intergovernmental immunity had its genesis in McCullock v. Maryland, 17 U.S. (4 Wheat.) 316 (1819). Weston v. City Council, applied the doctrine to taxes levied by the State upon the securities of the federal government while the Pollock decision extended that immunity to the interest paid on State and municipal bonds.

The ultimate result of Pollock was to invalidate the Revenue Act of 1894 because it unconstitutionally failed to apportion the income tax among the several States. In response to this result, the Congress passed the Sixteenth Amendment to the United States Constitution in 1913. But the debate in the United States Senate makes it clear that the Sixteenth Amendment was not intended to give to the Congress the power to tax the income from State obligations. It was conceded that such a power could destroy the federal system. See, 45 CONG. REC. 1696 (1910).

Just two years after the adoption of the Sixteenth Amendment, in Brushaber v. Union Pacific Railroad, 240 U.S. 1 (1916), the claim was made that the effect of the Sixteenth Amendment was to extend the class of subjects which could be constitutionally taxed by the Congress because of the inclusion of the phrase "incomes, from whatever source derived." After reviewing the history of the Sixteenth Amendment and its relation to the Pollock decision, the Court reached the conclusion that the Sixteenth Amendment did not expand the federal taxing power to include new subjects. 240 U.S. at 17-18.

This pronouncement of the law stood without serious challenge from 1916 until this decade. The provisions of Section 103 of the Internal Revenue Code do not create the tax exemption that applies to the interest paid by the States upon their bonds. They merely declared the existing law.

In Garcia v. San Antonio Metropolitan Transit Authority, 53 LW 4136 (1985), the Supreme Court notes that the States' continued role in the federal system is primarily guaranteed by the structure of the federal government itself. In this spirit, I implore the Senate to honor the historic doctrine of reciprocal governmental immunity and allow States to continue the borrowing which enables them to provide effectively the services which are so essential to the health and welfare of their citizens.

NAFCU

NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS
P.O. BOX 3769 WASHINGTON, DC 20007
(703) 522-4770

February 11, 1986

The Honorable Jake Garn
Chairman
Committee on Banking, Housing and
 Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for your letter of January 29, 1986, providing the National Association of Federal Credit Unions (NAFCU) with the opportunity to express our views on the impact which the House-passed "Tax Reform Act of 1985" (H.R. 3838) would have upon our nation's Federal credit unions. You will recall that on January 21, 1986, I wrote to you outlining those aspects of H.R. 3838 which cause the greatest concern among the Federal credit union community. Instead of reiterating those comments, I ask that my letter of January 21, 1986, as well as this letter be included in the official record of your Committee's hearings on the subject of tax reform. Mr. Chairman, on numerous occasions you have voiced your strong opposition to the taxation of credit unions. The credit union community applauds the leadership role you have consistently taken on this issue.

I would like to take this opportunity, however, to respond to remarks made by one of the witnesses appearing before your Committee on Wednesday, February 5, 1986. At the conclusion of his prepared remarks, the witness from the Independent Bankers Association of America stated that the tax exempt status of credit unions is an inequity that should be rectified. In making this statement, he asserted that credit unions have "broad bank-like powers which enable them to present strong and unfair competition to banks". For the record, I feel constrained to point out the flawed rationale upon which the witness relied in making his remarks.

While credit unions offer some services which resemble those available at commercial financial institutions, it is specious to assert that they "compete" with commercial financial institutions. Unlike banks and savings and loan associations, credit unions may not serve the general public. Federal credit unions may provide services only to limited fields of membership. The members of every credit union must share a common bond of occupation, association or geographic relationship. Notwithstanding statements to the contrary, there is no evidence to indicate that an increasing number of community charters are being granted to Federal credit unions over other types of charters.

Federal Credit unions were chartered by the Congress more than 50 years ago for the specific purpose of providing low cost financial services to consumers. Credit unions remain dedicated to that mission today. Unlike banks and thrifts, Federal credit unions are prohibited by law from offering commercial loans. In addition, credit unions are far more restricted in the scope of their investment authority.

If credit unions have any advantage, it is because of their nonprofit, cooperative nature. Credit unions are able to offer services at costs lower than those charged by commercial financial institutions because they depend heavily on the work of volunteers. More than 250,000 volunteers serve our nation's credit unions.

The witness suggested that credit unions are not subject to the same regulatory requirements which banks must satisfy. We find no merit in this statement. Federal credit unions are regulated by the National Credit Union Administration. They are visited by federal examiners on an annual basis. In addition, as you know Mr. Chairman, federally insured credit unions have made a far greater commitment to the safety and soundness of their federal deposit insurance fund than have their bank and savings and loan counterparts. On January 21, 1985, in accordance with provisions contained in the "Deficit Reduction Act of 1984", all credit unions with federal insurance were required to deposit with the National Credit Union Share Insurance Fund (NCUSIF) an amount equal to 1% of their insured shares. Federally insured credit unions must, by law, maintain their deposit at 1% should their shares increase and if necessary replenish the deposit if it is expensed by the NCUSIF. In 1985 this deposit bolstered the NCUSIF by approximately $850 million and effected a dollar for dollar reduction in the federal deficit. The NCUSIF estimates that this year insured credit unions' additions to their deposits in the Fund will total $105.3 million. These deposits, when added to NCUSIF investment earnings, will yield an additional net reduction to the deficit in 1986 of $209.3 million.

The credit union tax exemption is a reflection of the unique role credit unions play in the financial services marketplace. Given the factors which distinguish credit unions, it is difficult to understand how critics can characterize the tax exemption granted credit unions as an inequity.

Mr. Chairman, you and the members of the Committee on Banking, Housing and Urban Affairs are in a position to appreciate the differences among various providers of financial services. As your colleagues on the Committee on Finance deliberate the specifics of their tax reform proposal, the National Association of Federal Credit Unions asks you to advise them of the unique functions which credit unions play in the provision of financial services. We ask your continued opposition to the taxation of credit unions.

Sincerely,

Robert A. Hess
President

NAFCU

National Association of Federal Credit Unions
P.O. Box 3769 Washington, DC 20007
(703) 522-4770

January 21, 1986

The Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I would like to thank you for inviting the National Association of Federal Credit Unions (NAFCU) to comment on provisions contained in the House-passed tax reform package (H.R. 3838) affecting our nation's member-owned credit unions. I will limit my comments to three components of that proposal: 1) taxation of credit unions; 2) authority for credit unions to sponsor 401(k) plans; and, 3) linkage between 401(k) or 403(b) and IRA contribution limits.

1) Taxation of Credit Unions

The House Ways and Means Committee, during markup of H.R. 3838, considered and rejected the proposal that credit unions should be subjected to a federal income tax. In fact, the Committee went so far as to consider dividing the credit union community by size, and taxing only the larger credit unions. Significantly, the Ways and Means Committee soundly rejected all proposals to tax credit unions, regardless of size.

I would like to thank you, Mr. Chairman, and the other members of the Committee who have consistently expressed their strong sentiments in support of preserving the existing federal tax treatment of credit unions. Your support is greatly appreciated.

2) Authority for Credit Unions To Sponsor 401(k) Plans

If Section 1111 (b)(3) of H.R. 3838 were enacted into law in its present form, credit unions would be prohibited from offering qualified cash or deferred arrangements such as 401(k) plans to their employees. Section 1111 (e)(5) would, however, grandfather those credit unions who already had such plans in operation if they had applied to the Internal Revenue Service for a determination letter prior to November 6, 1985.

We question the rationale for prohibiting credit unions from instituting such plans. Since Federal credit unions were established by Congress for the specific purpose of promoting thrift it is consistent with that Congressional mandate for credit unions to promote thrift among their employees by establishing within the credit union a qualified plan such as that authorized under Section 401(k) of the Internal Revenue Code. In fact, utilization of a deferred savings plan such as a 401(k) plan seems more consistent with fundamental credit union goals and values than with the goals and values of commercial enterprises. Yet, under the House-passed bill, commercial enterprises could continue instituting 401(k) plans, while credit unions would be denied this opportunity.

Specifically, we recommend that Section 1111 (b)(3) of H.R. 3838 be amended by striking the period at the end of line 14 on page 810 and inserting the following: "or to any plan maintained by any credit union as defined in 12 U.S.C. 1752."

3) Linkage Between 401(k) or 403(b) and IRA Contribution Limits

Section 1101 of the House-passed tax bill addresses issues related to the coordination of IRA deductions with other elective deferrals. Under the coordination rules of the bill, an individuals' IRA deduction limit for a taxable year is reduced, dollar for dollar, by the amount of an individual's elective 401(k) or 403(b) deferrals for such year. If the Senate were to concur and this formula were to become law, many credit union members would effectively be precluded from opening new or making further contributions to existing credit union IRA accounts. Such a result could have an extremely detrimental effect upon member-owned credit unions.

In recent years many credit unions introduced IRA accounts solely to meet an emerging need of their members. Five years ago Congress enacted the "Economic Recovery Tax Act of 1981" ("ERTA"). That Act extended IRA availability to all taxpayers with earned income. In response to the underlying public policy objective of encouraging savings for retirement reflected in ERTA, many credit unions invested substantial sums of money and even more substantial hours of volunteer and professional staff time to research, institute and encourage their member to establish Individual Retirement Accounts. These savings have developed into a very stable deposit base for credit unions; a deposit base that could quickly be eroded if this provision were to become law.

We do not dispute the finding contained in the House Committee Report which states that:

> ...Since 1981, many employees have adopted qualified cash or deferred arrangements, which permit employees to make discretionary contributions that are provided with tax-favored treatment essentially equivalent to IRA contributions. However, the limits on elective deferrals under cash or deferred arrangements are much higher than limits on IRA contributions...
>
> House Report 99-426; page 683

However, we question the wisdom of establishing coordination rules which require the dollar for dollar reduction of IRA contribution limits by the amount placed in an individual's 401(k) or 403(b) plan, when IRA contributions are already restricted to an annual contribution of not more than $2,000 for an individual nor more than $2,250 for a spousal account. It would be far more equitable, if any type of off-set were to be legislated, to permit the taxpayer to elect how the off-set should be applied. We recommend allowing the taxpayer to decide whether the IRA limit should be reduced dollar for dollar by the amount contributed to a 401(k) or 403(b) plan, or conversely, whether the 401(k) or 403(b) contribution limit should be reduced by the amount contributed to an Individual Retirement Account. Such action would be totally consistent with the public policy viewpoint expressed in the House Committee Report that:

> ...In particular, the Committee believes that qualified cash or deferred arrangements should be supplementary retirement savings arrangements for employees; such arrangements should not be primary employer-maintained retirement plans...
>
> House Report 99-426; pages 686-687

Mr. Chairman, once again I would like to thank you for providing the National Association of Federal Credit Unions (NAFCU) with this opportunity to comment on the House-passed tax bill. If you or your staff would like to discuss any of the points raised in this letter or if you desire further information, please do not hesitate to contact our Director of Government Affairs, Bill Donovan, at 522-4770.

Sincerely,

Robert A. Hess
President

Statement of the NATIONAL ASSOCIATION OF HOME BUILDERS before the

Committee Senate Finance Committee

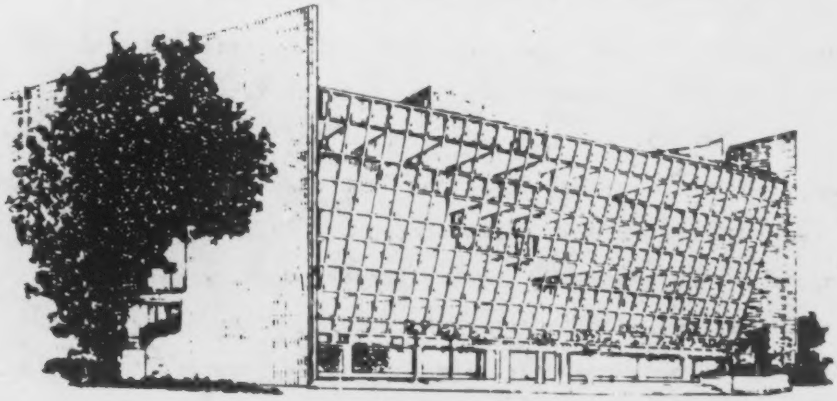
Subcommittee on Taxation and Debt Management

Subject Multiple-Class Mortgage-Backed Securities

Witness

Date January 31, 1986

Place



National Housing Center
15th and M Streets, N.W.
Washington, D.C. 20005
(202) 822-0470

Mr. Chairman and Members of the Committee:

The National Association of Home Builders, a trade association representing 137,000 members, is pleased to submit a statement for the hearing record concerning multiple-class mortgage-backed securities. NAHB strongly supports the goals of S. 1959, introduced by Senator Chafee, and S. 1978, introduced by Senator Cranston, both of which will eliminate impediments to growth in the market for mortgage pass-through securities -- a major component of the overall secondary mortgage market.

In the past, the role of the secondary market was primarily to help solve regional differences in the cost and availability of mortgage credit. Today, the secondary mortgage market links the capital and mortgage markets largely through sales of mortgages in the form of pass-through securities that have attracted investors from outside the traditional mortgage investment community.

Before presenting the statement, I would like to briefly address recent efforts aimed at weakening the federally related secondary market participants -- the Federal National Mortgage Association (FNMA), and the Federal Home Loan Mortgage Corporation (FHLMC), and the Government National Mortgage Association (GNMA). Last year, NAHB worked aggressively in opposition to a proposal to impose or increase user fees on these secondary market entities. Strong secondary market outlets for mortgage loans to moderate-income homebuyers are imperative in order to provide affordable funds for this group of purchasers. If the Government imposes user fees on FNMA and FHLMC and increases fees for GNMA, then the cost would be passed through to homebuyers and would reduce the number of families that could qualify for a home. The effect of such fees would fall particularly hard on first-time homebuyers. We are very concerned about the user fees on housing programs that have been proposed in the Administration's FY '87 budget. These fees are even higher than those in the proposal that was rejected last year. We must categorically oppose these efforts to weaken or eliminate the programs which have made home ownership possible for so many American families.

It is equally important that these secondary market purchasers be allowed to participate in mortgage-backed security programs on an equal footing with private conduits. Although both S. 1959 and S. 1978 allow participation by FNMA, FHLMC and GNMA, the tendency of some to oppose this participation makes it important to further clarify NAHB's position. NAHB strongly supports the inclusion, directly and indirectly, of FNMA, FHLMC, and GNMA in these transactions and will actively oppose any provision that disallows their full participation. FNMA, FHLMC, and GNMA, created by Congress to develop the residential secondary market, have been important elements in the continuing growth and evolution of secondary market activities. In these secondary market participants, the Congress has made available a tool through which cost-effective financing can be provided. FNMA, GNMA and FHLMC largely complement rather than compete with private lenders and suppliers of funds, and we cannot support an effort to put the housing finance markets in a position in which it is more profitable to serve the largest and wealthiest customers.

Mortgage Backed Securities under Current Law

The first mortgage pass-through securities were issued in 1968. By the end of 1985, outstanding mortgage securities had grown to nearly $400 billion. Since the first issuance, the market has developed a variety of instruments which have attracted investors because of their safety, yield and liquidity.

The development of mortgage-backed securities has increased the supply of mortgage money going into home loans by providing originators with an outlet for their portfolios of residential mortgages. Furthermore, as the secondary market has become more sophisticated and as more products have been introduced, the relative cost of mortgage money has decreased.

Second, the liquidity provided to financial institutions, particularly through mortgage/securities SWAPs, has provided originators with an alternative for their mortgage loan portfolios. This has been particularly helpful as institutions -- thrifts in particular -have attempted to restructure their assets and reduce maturity mismatch. Without the mortgage-backed securities market, it is doubtful that a substantial number of 30-year fixed-rate mortgages would still be available. We would expect additional positive influences on the mortgage market if tax laws are updated to reflect the concepts proposed in the two bills being considered.

Current tax rulings that apply to mortgage-backed securities generally were designed for other types of securities and have made tax law applications cumbersome to both investors and issuers. The introduction of collateralized mortgage obligations (CMOs) in 1983 by the Federal Home Loan Mortgage Corporation allowed a certain degree of flexibility to investors in mortgage-backed securities by permitting issuance of separate classes of instruments in quasi-maturity classes or "tranches" that appealed to different classes of investors. However, a CMO is a debt instrument for accounting purposes; the issuing institution retains ownership of the mortgages and issues bonds secured by the mortgages. This arrangement often requires over collateralization. Moreover, current original issue discount (OID) rules can create tax liability for some issuers that is not reflective of the flow of economic benefits being produced by the underlying collateral.

Pass-through trust arrangements hold a number of advantages over the current debt structure of CMOs for some issuers and investors. One advantage is that the institution sells the mortgages into a trust -- a real plus for institutions with limited capital positions that cannot show excessive leveraging on their books and with a desire to restructure asset portfolios. A second advantage is that purchasers of pass-through securities -- such as thrift institutions -- may classify the pass-through securities as eligible mortgage assets under various federal laws and regulations that impose a "qualified lender test." In terms of homebuyers, the "maturity slicing" associated with multi-class pass-through securities can lower rates paid on mortgage loans, particularly when short-term rates are below long-term rates in the market.

Under proposed Treasury regulations, a mortgage investment trust qualifying for pass-through tax treatment must provide terms of investment that are essentially fixed when the trust is created, and where only one class of securities may be issued against the trust. It is mainly the multiple-class structure, however, that produces lower interest rates for homebuyers.

S. 1959 and S. 1978

NAHB supports both pieces of legislation being considered. These bills, while accomplishing the same basic objective, approach MBS tax clarification differently. Each bill proposes a solution which will be more attractive than current law to investors in the secondary market as well as to issuers of the securities. Both bills provide for multiple classes of ownership which facilitate the predictability of payments to investors. Each would offer call protection through multiple-class mortgage-backed securities, as well as allow the sale-of-assets accounting treatment for multiple-class securities. Since investors would own the underlying collateral, taxation of phantom income at the issuer level would be eliminated. Moreover, neither bill requires over collateralization of the underlying assets.

Both S. 1959 and S. 1978 provide for a clarification of OID rules to permit the proper assignment of tax liability to parties receiving the economic benefit from the underlying collateral. On this issue, NAHB feels the OID regulations need to be specifically spelled out in the legislation in order to provide clear interpretation for the Department of Treasury. For this reason, we prefer the approach in S. 1959 which prescribes the regulations in legislative language rather than leaving that subject open to interpretation by the Treasury Department. A lack of specificity leaves the rule makers without clear direction, and could result in regulations not fully in line with the intent of Congress.

On the remaining differences, S. 1959 creates a new trust or pooling device, while S. 1978 amends requirements of the current "grantor trust" to permit multiple-class pass-through securities. Because both bills remove impediments in current tax law, we do not view one approach as superior to the other on these grounds.

Conclusion

In summary, NAHB would like to emphasize its strong support for the goals of both S. 1959 and S. 1978. Clarification and modernization of current tax applications for multiple-class, mortgage-backed securities will both increase the breadth and depth of secondary markets and exert a downward influence on mortgage interest rates, making it easier for homebuyers to obtain affordable mortgage credit.

NAHB specifically supports legislative instruction on OID regulations to remove any element of doubt regarding Congressional intent. In addition, specific legislative inclusion of FNMA, FHLMC and GNMA participation will assure equal secondary market access for lenders serving first-time and moderate-income households in our society.

NAHB appreciates the opportunity to submit this statement for the hearing record.

National Conference of State Legislatures

444 North Capitol Street, N.W.
Suite 203
Washington, D.C. 20001
202 624-5400

President David E. Nething
Majority Leader
North Dakota Senate

Executive Director
Earl S. Mackey

February 12, 1986

The Honorable Jake Garn
Chairman
Senate Committee on Banking,
Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

On behalf of the National Conference of State Legislatures (NCSL), I appreciate the opportunity to submit a statement for the record on the position of state legislators on the House passed tax bill (H.R. 3838). NCSL represents all 7,461 state legislators in the fifty states and has adopted specific resolutions on a number of issues under consideration in tax reform proposals through our policy making process. We are particularly concerned with provisions in the House passed bill relating to the treatment of tax exempt bonds. NCSL is pleased that the House retained the deduction for state and local taxes.

State legislators have been extensively involved in legislation dealing with tax exempt bonds. In recent years, legislatures in many states have enacted laws to allocate their state volume cap and some states have considered legislation to restrict the use of bonds.

Tax exempt financing is one means of insuring that capital needs are met and that necessary public services are available to the public. Over the past several years, the responsibilities of state and local governments have increased due, in part, to the reduction in federal funds. Because of balanced budget requirements, many states have found it necessary to increase taxes in order to meet the needs of the public. Clearly, the Gramm-Rudman-Hollings proposal and other federal budget initiatives will mean a further dimunition in the federal role in financing necessary projects and services at the same time that states are faced with a growing need for infrastructure financing. It is likely that states will be forced to rely more heavily on tax exempt financing for necessary capital improvments.

The House passed tax exempt bond provisions severely restrict the ability of the state to finance crucial public purpose projects. This action follows the restrictions that were adopted in the Tax Equity and Fiscal Responsibility Act of 1982 and the Deficit Reduction Act of 1984. Despite these fairly recent statutory changes, NCSL is willing to discuss reasonable and effective restrictions on the issuance of bonds that are for the primary benefit of private users. Not all of the current offerings of bonds are public purpose and we are willing to assist the Committee in the development of more effective criteria to measure governmental purpose. We strongly believe that tax exempt financing should be available for public purpose projects and facilities and that the following issues of concern should be addressed during Senate consideration of tax reform proposals.

STATE AND LOCAL GOVERNMENT ISSUES IN H.R. 3838: FEDERAL TAX REFORM LEGISLATION

1. Effective Dates

The House bill contains a January 1, 1986 effective date for most provisions. This is most troublesome for the sections relating to tax exempt financing (Section 703). The provisions in the House bill relating to tax exempt bonds are extremely complex and greatly change current tax treatment. Since the bill specifies a January 1, 1986 effective date, it is virtually impossible for bond counsel to determine if various offerings will meet the provisions of a bill until the Senate acts and a conference committee agreement is reached. Failure to comply with the bill's provisions, however, may result in retroactive liability.

The effective date provision has markedly reduced the number of issues being offered in 1986. Several states have already been faced with the reluctance of bond counsel to provide assurance that proposed general obligation bond issues would be tax exempt. Unless this effective date is made more realistic, states will face serious difficulty in getting favorable opinion from bond counsel on most projects. We believe that an effective date of January 1, 1987 would allow for a more reasonable transition to any new provisions and would provide that the legislature could enact laws to comply with new requirements in their regular session. The specific proposals affecting tax exempt bonds are described below.

2. Major New Reporting Requirement Imposed

A last-minute provision inserted into H.R. 3838 requires (1) state and local governments to file 1099 forms for payments of income and property (real and personal) taxes received during a year on a taxpayer-by-taxpayer basis and (2) furnish the taxpayer with a written statement showing payments received from the taxpayer. Effective January 1, 1987, the first return to individuals would be required at the end of January 1987, and to the IRS by the end of February 1988. Aimed at improving taxpayer compliance, this provision places significant financial burdens on state and local governments to assemble information, prepare tapes and pay postage on mailings (Section 145).

3. New Definition of Tax-Exempt Bonds

H.R. 3838 rewrites many of the tax code provisions governing tax-exempt bonds and dramatically changes the definition of a "governmental" bond.

Section 701 establishes two major categories of bonds: essential function bonds and nonessential function bonds. In general, nonessential function bonds are taxable, although the proposal permits certain nonessential function bonds to be issued on a tax-exempt basis. Essential function bonds are distinguishable from nonessential function bonds by either of the following "tests":

- If more than 10 percent or $10 million, whichever is less, of the bond proceeds are "used" by persons other than a governmental unit, directly or indirectly, the bond is categorized as a nonessential function bond.
- If more than 5 percent or $5 million, whichever is less, of the bond proceeds are loaned to persons other than a governmental unit, directly or indirectly, the bond is a nonessential function bond.

This wholesale change in the treatment of bonds will disrupt public financings and intrude upon the authority of state and local governments to issue traditional governmental bonds. It imposes new and severe restrictions on governmental bonds and increases public project costs. Even with the complex new definition, questions remain on distinguishing essential versus non-essential functions.

If the present law definitional approach is not retained, the Internal Revenue Service will need to prepare a new set of regulations, which often take years to complete, and it will be permitted to exercise discretion to further restrict state and local governments through the regulatory process.

The House tax reform bill includes the following facilities in the nonessential bond category: airports, docks and wharves, mass commuting facilities, water facilities, sewer facilities, solid waste facilities, and tax increment bonds (now called qualified redevelopment bonds and subject to new restrictions). The inclusion of these types of facilities when publicly owned and operated in the nonessential function bond category illustrates flaws in the redefinition of bonds in H.R. 3838.

Other nonessential function purposes authorized to be financed on a tax-exempt basis are: rental housing, single family mortgages (until December 31, 1987), small-issue industrial development bonds, student loans, and not-for-profit hospitals and universities (501(c)(4) bonds).

The following nonessential function purposes which are permitted under present law are prohibited tax-exempt financing under H.R. 3838 if they fail the governmental-purpose tests: convention and trade show facilities, sport facilities, parking facilities, hydroelectric facilities, pollution control facilities for industry, electric energy and gas furnishing systems, local district heating and cooling facilities, and industrial parks.

Finally, the new definition seriously restricts public-private partnerships in two distinct ways:

o The existence of long-term management contracts and long-term service contracts with the private sector to provide services such as laundry, food and laboratory services in a public hospital will jeopardize the tax-exempt status of a bond if the nongovernmental limit is exceeded. We do not believe such a contract should jeopardize the tax exempt status of a bond or be included under a volume cap.

o Bonds used to finance projects where the public sector and private sector are partners such as solid waste; wastewater treatment; and inner-city revitalization projects combining retail, entertainment and public facilities will be designated as nonessential functions and subject to a volume cap. Public power agencies will not be able to sell freely their excess capacity to privately owned utilities if they want to retain their tax-exempt status.

4. Further Restrictions on Bonds Including General Obligation Bonds

Partially as a result of the new definitions and partly the result of a tightening of all restrictions, numerous other changes will make tax exempt financing more difficult.

o New and more complex arbitrage restrictions will severely limit the investment of note and bond proceeds by (1) restricting the amount of bond proceeds that can be invested (2) limiting the amount of interest that can be earned on invested proceeds, (3) dramatically reducing the "temporary" periods during which investments are unlimited and (4) requiring state and local governments to rebate arbitrage earnings to the federal Treasury if the gross proceeds of the issue are not completely spent within six months after the date of issue.

o A new early issuance restriction will make tax-exempt bonds taxable if 5 percent of bond proceeds are not spent within 30 days after the date of issue and the remainder of the proceeds (except a reasonable bond reserve) are not spent within three years. Competitive bidding requirements alone make this provision unworkable in many states, and impossible in the states where issuers are required by law to have all funds on hand before going to bid. In Georgia, for example, the state constitution requires that all proceeds be received by state before issuing any contract. The three year time limit would rule out major capital projects, and the provision that the Treasury Department could issue individual rulings allowing longer time periods because of "undue hardship" only adds to the confusion and uncertainty.

o New restrictions on the refunding of bonds more than 30 days prior to the date the bonds are retired limit the flexibility issuers will have to reduce interest costs and restructure their debt in order to eliminate burdensome convenant provisions. For example, no bond issue may be refunded more than twice and the aggregate amount of successive refundings may not exceed 250 percent of the original bonds (except to reduce interest costs.)

- Individuals must report all tax-exempt interest on their income tax returns.

- All issuers must file a report on every bond and note issue with the IRS.

5. New Unified Volume Cap Affects Governmental Bonds

H.R. 3838 increases the types of bonds that are subject to the new unified state volume cap, restricts the ability of states and localities to allocate their approved allocation to specific uses and subjects portions of essential governmental function bonds to the new unified state volume cap. This limits the ability of the states to make their own priorities and substitutes federal determinations for state choices.

In general, all nonessential function bonds are subject to the annual $175 per capita limit beginning in 1988. Airports and docks and wharves are exempted from the cap except for cargo handling facilities at airports and storage facilities at ports. For essential function bonds, if nongovernmental use is involved, the issuer must obtain a volume cap allocation to the extent that the nongovernmental use exceeds $1 million. This means an allocation must be received for a portion of governmental bonds. NCSL does not believe that any portion of a public purpose bond should be subject to a volume cap.

H.R. 3838 provides the same federal allocation formula as present law and continues to permit states to modify the formula by enacting legislation or having the governor issue an executive order on an interim basis. The federal law provides that at least $25 per capita (or not less than $30 million) must be reserved for not-for-profit organizations. This reserve cannot be modified by state law. Fifty percent of the remaining cap is set aside for housing under the federal allocation scheme, but state law may reduce this set aside. NCSL does not believe that volume caps are appropriate and would suggest that housing should be subject to separate treatment. Additionally, any state that issued more than $25 million in tax increment bonds between July 18, 1984 and November 21, 1985 is permitted to allocate $8 per capita (or not less than $8 million) for tax-increment bonds. Half of this allocation is to be taken from the housing set aside and half from the allocation that is generally available.

6. Provisions Reducing the Market for Tax Exempt Bonds

Three separate proposals will have a major impact on the bond market: the alternative minimum tax, the repeal of the interest deduction for banks and financial institutions, and certain provisions affecting property and casualty insurance companies.

- Alternative Minimum Tax: the interest earned on municipal obligations will be subject to taxation because individuals and corporations subject to the alternative minimum tax will have interest earned on tax-exempt "nonessential function" bonds issued after December 31, 1985 taxed at a 25 percent rate in tax years beginning after December 31, 1985. These include many public purpose bonds. The bill contains specific language that property and casualty insurance companies will be required to pay an alternative minimum tax of 20 percent beginning in taxable years after December 31, 1987 which includes tax-exempt interest earned on all tax-exempt bonds acquired after November 14, 1985. Thus, even general obligation bonds will be affected.

  NCSL does not oppose a minimum tax. However, such a provision will affect all bonds issued as their tax exemption becomes a matter requiring further research. Once the market is partially taxable, taxpayers might expect further changes. Treasury's insistence on inclusion of this bond interest as taxable ignores the data which Treasury has produced. These figures show that high income individuals and corporations do not avoid taxation because of municipal bonds. They rely on a plethora of preference items to shelter their income. A minimum tax on these other preference items is an appropriate means for making the tax system fairer.

- Deduction for Bank Carrying Charges: The 80 percent interest deduction banks and financial institutions are permitted for interest costs they incur to carry or purchase tax-exempt obligations has been eliminated in most instances as of December 31, 1985. A three-year transitional exception beginning January 1, 1986 allows up to $10 million in bonds annually for small local issuers to be eligible for the 80 percent interest deduction as long as (1) the obligations purchased are not nonessential function bonds and (2) the bonds are acquired by a financial institution authorized to do business in the state of the issuer. These securities are often used by depositories as collateral securities to secure public deposits that are not insured.

- Property and Casualty Insurance Companies: in addition to their separate treatment under the alternative minimum tax, these companies will be further discouraged from buying tax-exempt obligations as a result of another proposed tax code change. For tax years beginning after December 31, 1985, the deduction taken by property and casualty companies for loss reserves must be reduced by 10 percent of all the tax-exempt interest earned by the insurer. The percentage increases to 15 percent after December 31, 1987.

Finally, NCSL is planning to consider the implications of the housing provisions in the tax reform proposal during our next State-Federal Assembly, particularly the effect a reduction in the depreciation schedule on rental property will have on individuals unable to own a home.

Thank you for the opportunity to submit written testimony to the Senate Banking, Housing and Urban Affairs Committee. I look foward to working with the Committee on these important intergovernmental issues.

Sincerely,

Kathy Brennan Wiggins
for Earl S. Mackey
Executive Director

National Conference of State Legislatures

444 North Capitol Street, N.W
Suite 203
Washington, D.C 20001
202/624-5400

President David E Nething
Majority Leader
North Dakota Senate

Executive Director
Earl S. Mackey

TAX-EXEMPT FINANCING
August 8, 1985

A fundamental principle of the federal system of government is the Constitutional doctrine of reciprocal immunity. Therefore, the federal government cannot tax the interest on obligations issued by states and local governments for their facilities and states and local governments cannot tax the interest on federal obligations. No federal tax should be imposed, either directly or indirectly, on the interest paid on state and local government obligations issued to provide services to the public.

Notwithstanding the Constitutional basis of the exemption from tax of interest on obligations issued to provide services to the public, it may be possible to restrict the issuance of bonds that are for the primary benefit of private users. The increased volume of tax-exempt finances has adversely affected the cost of borrowing for "public purposes." So, a workable definition of "public purpose" should be developed to preserve the tax-exempt market for governmental borrowing.

The National Conference of State Legislatures does not support restrictions that affect state and local governments' ability to finance the basic infrastructure of our states, counties, cities and special districts. If these facilities are not provided, industrial and commercial activities that rely on governmental services such as highways, streets, sewers, water systems and schools will not be able to operate efficiently or survive financially.

Recognizing the need to respond to the federal interest in restricting tax-exempt bonds for private users, the National Conference of State Legislatures supports a definition of "public purpose bonds" that provide unchallenged tax-exempt financing for:

- general obligation and revenue bonds that are used to finance such projects as schools, roads, bridges and government buildings;
- industrial development bonds that are used to provide public services such as airports, docks, wharves, and water and sewer facilities;

- bonds for facilities that provide public services that are financed on a public/private partnership basis such as resource recovery facilities; and

- bonds that primarily private users that are targeted to areas of economic distress or to specific purposes where it is in the public interest to continue such tax-exempt financing.

The National Conference of State Legislatures opposes changes in existing federal tax laws, regulations or interpretations which could diminish the value of tax-exempt bonds for governmental purposes. These bonds should be free of severely restrictive arbitrage limits such as the requirement to rebate investment earnings on bond proceeds to the U.S. Treasury, prohibitions against all advanced refundings, and burdensome reporting requirements. Additionally, the National Conference of State Legislatures believes arbitrary volume caps are not an appropriate way to restrict tax-exempt bonds.

The National Conference of State Legislatures urges the Administration and Congress to work with members of NCSL and to determine and implement proper restrictions on the uses of these bonds.

JOINT STATEMENT OF

THE NATIONAL LEASED HOUSING ASSOCIATION

THE COALITION FOR LOW AND MODERATE INCOME HOUSING

THE COUNCIL FOR RURAL HOUSING AND DEVELOPMENT

CONCERNING THE IMPACT OF H.R. 3838 ON LOW INCOME RENTAL HOUSING

before the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

Submitted by:

Charles L. Edson, Esq.
Lane and Edson, P.C.
Washington, D. C.

February 12, 1986

Mr. Chairman and Members of the Committee. This statement on the impact of H.R. 3838 on low income housing is submitted for the Hearing Record jointly on behalf of the National Leased Housing Association ("NLHA"), the Coalition for Low and Moderate Income Housing (the "Coalition"), and the Council for Rural Housing and Development (the "Council") by Charles L. Edson of Lane and Edson, P.C., Washington, D. C., which serves as counsel to these organizations.

We commend the Chairman for initiating these important hearings. Clearly, this Committee has historically been in the forefront of designing policies to provide much needed low income housing. Members of this Committee have a deep understanding of housing policy and we hope that Senators from the Finance Committee will rely upon the wisdom of Banking, Housing and Urban Affairs Committee members when formulating tax code provisions relevant to low income housing.

Together, NLHA, the Coalition, and the Council represent businesses, nonprofits and public agencies with a great deal of knowledge and experience in the provision of low income rental housing. It is their common belief that the House-passed Tax Reform Act of 1985 will have seriously negative effects on the ability of the Nation to maintain its historic commitment to housing for lower income Americans. While the House bill did recognize the need for favorable tax treatment for low income housing in some respects, the overall legislation is likely to result in a virtual halt to new construction of such housing and a real threat to rehabilitating and preserving our valuable existing stock.

NLHA, the Coalition and the Council have developed jointly a paper entitled "Low Income Rental Housing -- A Proposal" which is appended to this Statement and which we ask to be included in the material to be inserted in the Record of this hearing. This paper is an attempt to devise a rational and fair proposal for the treatment of low income housing. We try to respond to legitimate concerns raised by the Congress that those who are most in need be served as much as possible, while recognizing that without tax incentives, investment will not flow into low income housing.

We appreciate the opportunity to submit this Statement. We would welcome the opportunity to work with Members of the Committee and their staffs in formulating Tax Code provisions that will provide the necessary ingredients for investment in low income housing.

NATIONAL LEASED HOUSING ASSOCIATION
COALITION FOR LOW AND MODERATE INCOME HOUSING
COUNCIL FOR RURAL HOUSING AND DEVELOPMENT

LOW INCOME RENTAL HOUSING - A PROPOSAL

I. Introduction

For almost 50 years, the Congress has carried out in a variety of ways a national commitment to decent, safe and affordable housing for low income persons. Since 1969, this commitment has included the provision of incentives contained in the Internal Revenue Code designed to produce and operate privately-owned multifamily housing for low income persons. Over the past several years, direct federal subsidies to construct this housing have been substantially eliminated, thus making the Tax Code incentives the only remaining tools to continue this national goal. It is important to emphasize that these incentives have resulted from considered policy decisions made by the Congress over a seventeen year period as an essential element of public policy.

The undersigned organizations -- the National Leased Housing Association, the Coalition for Low and Moderate Income Housing, and the Council for Rural Housing and Development -- represent businesses, non-profits, and public agencies across the country with deep knowledge and experience in the development, financing and management of low income housing. They have worked closely with Congresses and Administrations over the past two decades in formulating and improving national policies to foster the production, management and preservation of low income housing.

There can be little doubt that tax incentives are necessary to spur private investment in low income housing. Investment will flow into a real estate transaction for three reasons: cash return, possibility of long term appreciation, and tax benefits. With low income housing, the first two reasons are essentially non-existent. Either as a matter of govenrmental regulation or because the income levels of the tenants do not permit rent levels adequate to support a development, there is generally little or no cash flow generated. Market appreciation may be restricted by government regulation which prohibits the use of the property for anything but low income housing for a decade or more, or market forces may lead to the same result. Thus, the only financial incentives are the benefits stemming from the Tax Code.

Furthermore, the need for low income housing continues, particularly in light of the elimination of federal production programs. Waiting lists for assisted housing opportunities and the growing numbers of families who are homeless because of their inability to find affordable housing are stark evidence of this national problem.

Certain aspects of the House-passed Tax Reform Act of 1985 did recognize the special needs of low income housing. However, other provisions, including the imposition of the Alternative Minimum Tax on "passive activity losses" more than offset these features. Overall, the House bill would seriously undermine the Nation's ability to provide needed low income housing.

II. Proposals

The undersigned organizations urge the Senate, in its consideration of tax reform legislation, to adopt the following provisions relating to low income housing. (For convenience, a brief summary of the corresponding provision in the House-passed bill is included).

1) Definition of Low Income Housing

In addition to the present definition of "low income housing" contained in Section 1250 of the Code, a new definition of that term should be adopted. In order to qualify, developments should meet one of two tests: either a) 25% of the project's dwelling units are rented to households whose incomes do not exceed 80% of area median income, or b) 20% of the units are rented to households not exceeding 70% of median.

In addition to the new definition, the present Section 1250 definitions should be retained. Generally, such definitions incorporate projects subsidized under extinct subsidy programs (e.g., Section 8, Section 236, etc.) However, to preserve the existing projects subsidized under these programs, the old definition should be retained so that such projects will continue to have favorable tax treatment on resale. Resale becomes essential at such time as an existing owner loses the financial incentive to operate the project.

(House bill - Defines "low income housing" in the same manner as proposed above. In addition, it defines "very low income housing" as projects in which 40% of the units are rented to households at/below 60% of median. This is an unrealistic definition as there is no available subsidy program that could allow for rents low enough that would be affordable by tenants at this level; accordingly, the House created a category into which no project can fit. Bill Sec. 201, proposed Section 168 (j)(3) of the Code. If the Senate decides that it is desirable to have a two-tier definition based upon targeting, it must make that targeting more realistic.)

2) Depreciation for Low Income Housing

Assuming the Senate adopts similar depreciation periods overall as are in the House bill, low income housing, as defined above, should receive a 20 year recovery period with the 200%

declining balance method. If the two-tier definition approach is to be utilized, the "very low income" tier should receive substantially more advantageous depreciation in order to compensate for whatever greater targeting is to be required.

(House bill -- Low income housing received 30 year/200% depreciation, which represents approximately a 50% reduction from present law treatment. This depreciation will make low income projects financially infeasible. Very low income housing, as defined in the bill, received 20 year/200% treatment. Section 201 of the bill, proposed Section 168(e)(2)(A) of the Code.)

3) Alternative Minimum Tax

As explained above, private investment in low income housing is generated by tax benefits. These benefits generally take the form of limited partnership losses which serve to shelter other income. If a "passive activity loss" provision like the one included in the House bill were to be enacted, then any other positive features related to low income housing in this legislation would be virtually eliminated. Therefore, if a "passive activity loss" measure is to be part of this bill, it should exempt low income housing. Furthermore, this provision should not be retroactive by including within its scope losses from existing partnerships as is provided in the House bill. In other words, if the policy decision is made to utilize tax incentives to encourage low income housing, then this policy should not be thwarted by putting losses from low income housing under the Alternative Minimum Tax.

In addition, if interest earned on multifamily housing bonds is treated as a preference item for AMT purposes, rents will have to be raised in developments financed by such bonds to compensate for the increased debt service costs which will be occasioned by subjecting these bonds to the 25% AMT rate. This factor may make many of these projects financially infeasible. Therefore, interest on multifamily bonds should not be treated as a preference item under the AMT.

(House bill -- "Excess passive activity losses", defined as the amount of net losses from such activities in excess of a taxpayer's cash basis in non "tax shelters" and the lesser of $50,000 or the taxpayer's cash basis in "tax shelters", are effectively treated as preference items for the AMT. Interest earned on "nonessential function bonds", which include multifamily housing bonds, is also treated as a preference item. Section 501 of the bill, proposed Sections 58(b) and 57(a)(6) of the Code.)

4) At-Risk Rule

Low income housing, as defined above, should continue, as under present law, to be exempted from the application of the at-risk rule. Exemption from "at risk" is essential if the utilization of tax incentives for low income housing is to be meaningful. (Also see discussion below under "Technical Concerns Arising Under H.R. 3838".)

(House bill -- All real estate, including low income housing, continued to be exempted from the at-risk rule, except for nonrecourse seller financing. Section 401 of the bill, proposed Section 465(b)(6) of the Code.)

5) Interest Deduction Limitations.

Low income housing should be exempted from any new limitations placed on the deductibility of interest. The exemption should apply regardless of the source of the financing on the development and regardless of whether the financing was generated by the issuance of tax-exempt bonds so long as the definitions set out above are satisfied.

(House bill -- Deductions of "nonbusiness" interest, which is defined to include interest expense allocable to a limited partner, would be limited to the sum of $20,000, plus interest payments on indebtedness secured by two homes, plus net investment income. Exemptions are provided for very low income housing and for low income housing but in the latter case only if the project is financed by tax-exempt bonds. Low income projects financed with conventional loans or under the Farmers Home Administration Section 515 program, which is a major source of financing in rural America, would not receive this exemption. This distinction has no rational basis. Exemption from the interest cap should rest on who is served by the program, not who finances it. Section 402 of the bill, proposed Section 163(d) of the Code.)

6) Capital Gains Treatment

Low income housing should continue, as under present law, to be accorded capital gains treatment upon sale or other disposition.

(House bill -- Depreciable property, including real estate, continued to be accorded capital gains treatment upon sale or other disposition. Section 241 of the bill, proposed Section 1202 of the Code.)

7) Construction Period Interest and Taxes

As under present law, interest and taxes incurred during construction of a low income development should be deductible currently. This major incentive for low income housing development is necessary to attract investors to such housing.

(House bill -- Present law, which permits current deductions for construction period interest and taxes, is repealed and replaced by a provision requiring capitalization of such expenses. Section 905 of the bill, proposed Section 263A of the Code.)

8) Section 167(k)

The present law which allows a five year amortization of rehabilitation expenditures for low income housing should be made permanent and the expenditure limitation of $20,000 per dwelling unit (which was established in 1976) should be increased, to reflect inflation, to $30,000 per unit.

(House bill -- Adopted the position outlined herein. Section 223 of the bill, proposed Section 167(k) of the Code.)

9) Tax-exempt Bonds for Multifamily Housing

Multifamily housing bonds should continue to be available to finance low income housing, but with the targeting definition for "low income housing" described in paragraph 1. Such bonds should not be subject to the unified state volume limitation. Otherwise, states will reallocate the cap away from the necessary but often politically unpopular item of low income housing to the more politically attractive industrial development bonds. Family size adjustments should not apply to projects occupied predominantly by the elderly, because applying such adjustments to elderly projects, which generally contain only efficiency or one-bedroom units, would make these projects financially infeasible.

(House bill -- Continues to authorize the issuance of multifamily housing bonds with the targeting definition of "low income housing", which is the same as being proposed here. Subjects such bonds to a unified state volume limitation; although $75 per capita in each state is set-aside for veterans', single family, and multifamily bonds, the set-aside can be overridden by the state. Family size adjustments are required with no exception for the elderly. Section 701 of the bill, proposed Section 142(c) of the Code.)

III. Technical Concerns Arising Under H.R. 3838

1) At-Risk Rule

The House bill provided that the revised at-risk rule, which would repeal the present law exemption for real estate insofar as it applies to seller financing, would be effective as to losses attributable to "property acquired" after December 31, 1985. (Section 401 of the bill.) The Ways and Means Committee Report (p. 295 of H. Rpt. 99-426) states that "property acquired" includes not only property acquired by a partnership but also interests in the partnership itself. The effect of this language will be to penalize partners who wish to sell their interests in partnerships which have acquired before 1986 existing property which was seller financed. The purchaser of such a partnership interest, under the Committee's language, would not be able to take into basis the seller financing portion of any debt, thus reducing substantially the value of and liquidity of the existing partner's interest. Thus, the Ways and

Means Committee has effectively made this provision retroactive with a very unfair result. The rules governing investments should not be drastically altered in this retroactive fashion to the great detriment of investors who made good faith decisions based on existing law. Controlling seller financing of property being acquired by an entity, which is the goal sought by the House bill, can still be accomplished by exerting that control at the ownership (e.g., partnership) level of that property and not by penalizing the partners' interests in the partnership itself as this Report language seeks to do.

If the Senate adopts the legislative language from the House bill on the at-risk rule, it is suggested that the Finance Committee Report explicitly state that:

> In the case of a partnership or S Corporation, property acquired means only property owned by the partnership or S corporation and not interests in the partnership or stock in the S corporation.

2) Recovery Period for Multifamily Housing Financed with Tax-Exempt Bonds

Under an anomaly contained in the House bill, in tax-exempt bond financed multifamily housing developments in which

a) the bonds are issued on or before December 31, 1985;

b) the development is placed in service on or after January 1, 1986 and does not qualify for transition rule relief (i.e., binding contract or construction commencement after September 25, 1985); and

c) the bond documents qualify for tax-exemption under Code provisions applicable in 1985,

the development would be required to use a recovery period of 40 years, rather than the 30 year period specified in H.R. 3838 or the 19 year period applicable under present law. This is the case even though the property is 20% low income and meets the other tests for qualified tax-exempt bond financing under present law -- the law in existence when the bonds were issued. The failure to meet the new rules governing multifamily housing bonds which are to be effective after 1985 causes the property to be considered bond financed non-low income housing. All such non-low income property must use 40 year straight-line depreciation under the House bill. (Sections 203 and 703 of the bill).

This unfair and unintended result should be rectified by adding to Section 203(c)(2) of the bill the following language.

(E) LOW INCOME HOUSING. - In the case of projects for residential rental property described in section 103(b)(4)(A) as in effect on December 31, 1985 financed with tax-exempt bonds, the provisions of subparagraph (C) of section 168 (b)(3) shall not apply.

* * * * *

The undersigned organizations would be pleased to work with Senators and their staffs toward the goals outlined in this paper. Please feel free to call upon Charles L. Edson (955-9779) or Richard S. Goldstein (955-9718), both of Lane and Edson, P.C. for further assistance.

National Leased Housing Association
The Coalition for Low and Moderate Income Housing
Council for Rural Housing and Development

National
Low Income Housing Coalition
1012 Fourteenth Street, N.W., Suite 1006, Washington, D.C. 20005 • (202) 662-1530

Hon. Edward W. Brooke, *Honorary Chairperson*
Barry Zigas, *President*

SUMMARY OF RECOMMENDATIONS FOR NEW PROVISIONS FOR LOW INCOME HOUSING IN H.R. 3838

1. Predominantly Low Income Housing (PLIH)

H.R. 3838 is extremely prejudicial to the 600,000 units of existing, already subsidized HUD-FHA-insured multifamily rental housing. This housing is reaching the end of the tax recapture period from its initial construction, and owners are seeking to recover their equity after nearly 20 years. Favorable tax treatment is essential to help structure transfers of these properties which assure the continued availability of the units to the low income tenants now being served.

H.R. 3838 also provides no incentives to develop property for predominantly low income use. This is a major retreat from current law, which provides the most generous depreciation treatment for properties which do serve a predominantly low income tenancy.

The Senate Finance Committee should adopt a new class of rental property: Predominantly Low Income Housing (PLIH). Qualifying projects would include:

- Any project--existing, newly constructed, or rehabilitated--in which 80 percent or more of the units are occupied by households with incomes below 80 percent of area median, adjusted for family size.
- Any project insured under Section 236 or Section 221(d)(3)(BMIR) of the National Housing Act, as amended, or the direct loan programs of the Farmers Home Administration under Title V of the National Housing Act, as amended.

Such properties would qualify for the following special consideration:

- Depreciation of investment on a 10-year, 200 percent schedule. Recapture of all depreciation benefits would occur if transfer occurred within the first 10 years, with the penalty declining over the second 10 years to zero. Transfer to any purchaser which agrees to maintain low income occupancy, or to a qualified limited equity low income cooperative during the first 20 years would exempt the seller from recapture.

- This depreciation treatment would apply to acquisition as well as development, construction, or rehabilitation expenses.

- PLIH acquisition could be financed through the issuance of tax-exempt housing bonds. Bonds issued for this purpose would be classified as serving an "essential governmental purpose" and be exempt from any other volume or issuance caps enacted.

- PLIH properties would be excluded from at-risk treatment, as outlined below, and from limitations on business interest. Income and losses from PLIH investments would not be treated as preference items for purposes of the alternative minimum tax.

2. Qualifying as "Mixed Income Housing"

H.R. 3838 adopts two specific means by which to qualify for special tax treatment in rental housing. It calls these "low income housing" and "very low income housing". Both descriptions are inaccurate--the targeting thresholds provided for (at least 25 percent low income occupancy in the one case, and at least 40 percent occupancy in the other) only provide for "Mixed Income Housing." The separate classes established by H.R. 3838 should be replaced by a single definition of **"Mixed Income Housing"** requiring that:

- At least 20 percent of the units occupied by households with incomes below 80 percent of median.

- At least 10 percent of the units occupied by persons below 50 percent of median.

The remaining 70 percent of the units may be occupied by any household, and may be rented at whatever the market will bear. All targeted units, however, must rent at not more than 30 percent of 80 percent (or 50 percent for the 10 percent set-aside) of the area median.

Projects which meet the minimum targeting requirements of the **Mixed Income Housing** definition would qualify for a 20 year, 200 percent depreciation schedule. This still represents a 39 percent reduction from the benefits now available under the 15 year, 200 percent depreciation available to low income housing. This schedule should permit the widespread use of this targeted program, however.

3. Projects exceeding the minimum targeting requirements

Particularly in the nonprofit sector, sponsors may want to exceed the minimum targeting requirements of the Mixed Income Housing definition, but not reach those of the Predominantly Low Income Housing definition. In instances where the owners provide more than the minimum number of units to either those below 80 percent or 50 percent, each additional unit over the threshold shall receive 5-year, 100 percent depreciation through the provisions of Section 167(k), on a unit-by-unit basis as long as the unit is occupied by a qualified tenant. This provides a substantial incentive for attracting investment capital to projects exceeding the minimums.

4. Tax exempt bond authority

Projects meeting the minimum threshold for Mixed Income Housing or Predominantly Low Income Housing would qualify for IDB financing. The present cap on IDB issuances should be abandoned, or housing should at the very least be provided a cap outside the other bond limits imposed. In any case, PLIH issuances should be qualified as an "essential governmental purpose" and remain outside any caps imposed.

5. Other real estate provisions--At Risk and Interest Limitations

All projects qualifying as either Predominantly Low Income Housing, Mixed Income Housing, or units developed through Section 167(k) would be exempt from the **at-risk** limitations and the **interest limitations.** The **at-risk** exemption must be amended in Section 401 of H.R. 3838 so that qualified nonrecourse financing includes a new paragraph: "(e) which is used to acquire interests in property which is used and will be maintained as PLIH." Seller financing plays a major role in the transfer of existing PLIH property. Many such transfers would not be possible without such financing. Already adopted legislation concerning the Original Issuer Discount (OID) rules have curbed the abuses which concerned Congress in this area. The limitation included in H.R. 3838 is very favorable to highly leveraged, profit motivated new production deals most likely to be carried out through the Mixed Income

Housing provisions outlined above. But the limitation is extremely prejudicial to the continued viability and maintenance of existing Predominantly Low Income Housing.

6. Alternative minimum tax

The Alternative Minimum Tax as presently structured in H.R. 3838 eliminates any incentive to participate in low income rental housing syndications, regardless of the targeting or depreciation schedules used. It even makes use of the 167(k) option very marginal.

The Senate Finance Committee should exempt investments in qualified Predominantly Low Income Housing Projects, in qualified Mixed Income Housing projects, or in projects qualifying under Section 167(k) from inclusion as a preference item in the alternative minimum tax. **However, exemption should be premised on the adoption of the more stringent targeting requirements outlined above.**

7. Use restrictions on qualified properties

H.R. 3838 should be amended to require a use restriction on any bond-financed property or any property qualifying for treatment as Predominantly Low Income Housing or Mixed Income Housing of no less than 15 years from the start of full occupancy. The current use restriction of the greater of 15 years or the maturity of the bonds financing the project is impractical. It will discourage the use of longer term financing to carry out projects without providing any substantial increase in term of use for the affected tenants.

8. Anti-displacement provisions

H.R. 3838 should be amended to include stiff prohibitions against the use of tax-exempt financing in instances where low or very low income households will be displaced by those of higher income.

9. Qualifying low income, limited equity coops for IDB financing.

Under current law, cooperative multifamily housing projects do not qualify under the multifamily IDB provisions because of their unique characteristics. It is impractical to finance such developments using the single family bond program. Meanwhile, nonprofit sponsors throughout the country are gaining experience with the use of limited equity, low income cooperatives as an effective way to provide low cost housing over a long period of time to low income households. A strictly limited qualification should be enacted to facilitate the use of this model through IDB financing. Coops should be required to meet the PLIH standards to qualify for IDB financing, and should be required to meet certain additional standards concerning equity appreciation and long term use of the property as Predominantly Low Income Housing.

THE NEW YORK HOSPITAL
Chartered 1771
525 EAST 68th STREET, NEW YORK, N.Y. 10021

[illegible]

February 4, 1986

The Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
SD-534
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Garn:

We understand that on February 6, 1986, your Committee will be holding hearings on the Tax Reform Act of 1985. This letter is to comment for the record on the provisions of the bill, as passed by the House of Representatives, under which Section 501(c)(3) nonprofit hospitals are subject to certain state wide and per entity volume limitations, certain restrictions on advance refundings and new arbitrage restrictions.

These provisions will inhibit needed health care construction, renovation and modernization projects and the purchase and replacement of major movable medical equipment. The health care industry already has been subjected to cut backs in medicare funding and may be adversely affected by Gramm-Rudman budget balancing legislation. Limiting the access of nonprofit hospitals to the tax exempt bond market would deal a crippling blow to this vital public service sector.

The New York Hospital is a case in point. We filed a Certificate of Need Application in 1982 with the New York State Department of Health for a desperately needed modernization of our existing physical plant, which is more than fifty years old, in order to meet current regulatory codes and standards. The estimated capital cost of the total project, as filed, is

$395 million. To date, more than $1.5 million have been expended on the evaluation and planning necessary to implement this project. This amount is exclusive of in-house personnel hours. Additionally, this modernization plan is the final phase of an integrated program, begun by the Hospital in 1967, to solve its major problems while carrying on its mission of uninterrupted exemplary patient care.

The future of patient care at New York Hospital, which is so important to the citizens of New York State and the rest of the country, will be sorely compromised if the bill is passed in its present form. The final phase of our long-range plan will be derailed because we will be unable to meet the additional expense of financing this project on a taxable basis.

We appeal to you on behalf of Section 501(c)(3) nonprofit hospitals everywhere to exempt such hospitals from all of the above-described provisions of the bill.

For your information, I attach a copy of my letter of December 12, 1985 to Senator Moynihan, who is a member of the Senate Finance Committee. I sent an identical letter to Senator D'Amato.

Thank you for your consideration of these issues.

Very truly yours,

David D. Thompson

David D. Thompson, M.D.
Director

DDT:law
Enclosure

THE NEW YORK HOSPITAL
Chartered 1771
525 EAST 68th STREET, NEW YORK, N.Y. 10021

OFFICE OF THE DIRECTOR

December 12, 1985

The Honorable Daniel P. Moynihan
The United States Senate
The Capitol
Washington, D.C. 20510

Dear Senator Moynihan:

This urgent request is in reference to that provision of the Ways and Means Committee Bill HR 3838 which places a volume cap on tax exempt financing available to hospitals with 501-C3 status. It is imperative that The New York Hospital be included in Transitional Exemptions from the Volume Cap, the advance refunding restrictions for existing hospital bonds, and the arbitrage restrictions.

The New York Hospital filed a Certificate of Need Application in 1982 with the New York State Department of Health for a desparately-needed modernization of its aging physical plant to meet current regulatory codes and standards. The total project, as filed has a capital cost estimated at approximately $395 million. As of this date, more than $1.5 million has been expended on the evaluation and planning necessary to implement such a project. This figure is exclusive of in-house personnel man hours. Additionally, this modernization plan is the final phase of a totally-integrated program, begun by the Hospital in 1967, to solve its major problems while attending to its mission of uninterrupted exemplary patient care.

The future of New York Hospital patient care, on which the citizens of New York State have come to rely, will be sorely compromised if the Hospital is not granted a Transitional Rules Exemption from all of the above provisions of the Tax Reform Bill. The final phase of our long-range plan will be derailed because we will be unable to meet the additional expense of taxable bonds.

We appeal to your often-demonstrated concern for the viability of the institutions of the State which have healed so many of the world's sick, trained so many of the physicians responsible for major medical breakthrough, and employ so many of the State's citizens.

PIA
PROFESSIONAL INSURANCE AGENTS
GOVERNMENT AFFAIRS OFFICE
800 PENNSYLVANIA AVE. S.E. SUITE 203 WASHINGTON D.C. 20003
(202) 544-8713

February 7, 1986

The Honorable Jake Garn
Chairman, Committee on Banking,
Housing, and Urban Affairs
SD-534 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Dear Mr. Chairman:

Pursuant to your letter of January 28th, please find enclosed the requested copies of PIA's written submission for the hearing record on tax reform issues.

These statements, previously submitted to the Committee on Finance, set forth our views on the Administration's proposed taxation of employee benefits and the taxation of property and casualty insurance companies.

Please contact Charles W. Wegner, Jr., PIA's Director of Federal Affairs, should you have any questions regarding our positions.

Sincerely,

Patricia A. Borowski

Patricia A. Borowski
Vice President
Government/Industry Affairs

PAB:mgc

Encls. (6 ea.)

Statement by
The National Association of
PROFESSIONAL INSURANCE AGENTS

concerning
THE IMPACT OF TAX REFORM
ON THE INSURANCE INDUSTRY

UNITED STATES SENATE

October 1, 1985

The National Association of Professional Insurance Agents (PIA) is a national trade association representing more than 40,000 independent property and casualty insurance agents in all 50 States, the District of Columbia, Puerto Rico and the U.S. Virgin Islands.

PIA has closely followed the evolution of the tax reform proposal that is now before the Finance Committee. The provisions amending the tax treatment of property and casualty (P&C) insurance companies and employee benefits are of special interest.

We welcome this opportunity to express PIA's opposition to the insurance provisions contained in President Reagan's plan for a comprehensive revision of the Internal Revenue Code of 1954, as amended. Since this hearing will consider the impact of tax reform on the insurance industry, PIA's comments will be limited to the plan's tax treatment of P&C companies and how this would impact adversely on insurers, insurance agents and ultimately the insurance consuming public.

The controversy surrounding the tax treatment of P&C insurers centers around the following proposed changes:

1. The establishment of discounted loss reserves using the "qualified reserve account" (QRA) approach. This method would cover both stock and mutual P&C insurance companies.
2. The changes in tax benefits for mutual P&C companies.

(a) The repeal of the protection against loss (PAL) account.

(b) The repeal of tax provisions aiding small mutual insurers.

(c) The limiting of insurer deductions for dividends paid to policyholders.

PIA believes that the amendments outlined above should be rejected by the Committee.

Under current law, the taxable income of P&C insurers is taxed at the same rates that generally apply to other for-profit corporations. The computations used to determine taxable income for P&C insurers are obtained from the statutory annual statement that an insurance company must prepare and file to comply with the regulatory requirements of state insurance departments. This statement is based on the statutory accounting system developed by the National Association of Insurance Commissioners. Under statutory accounting, there is no discounting of reserves and acquistion costs are expensed immediately. The use of this accounting system, that is unique to the insurance industry, is mandated by state insurance regulations to help ensure that insurers will have adequate reserves available to finance loss payments on all claims that become due. Statutory accounting is an integral part of the regulatory programs that are designed to protect the public as consumers of insurance products. The current federal tax treatment of P&C insurers recognizes and reflects the statutory accounting rules that are essential to the financial soundness and stability of our industry and that have been the accounting basis for determining an insurance company's taxable income since 1921.

The Administration wants to change the current methodology for determining insurer taxable income because their entire reform package is based on the premise that there will be an expanded tax base. Obtaining that broader base has become a priority goal for the Administration. Their other priority goal is aggregate tax revenue neutrality. This apparently will be achieved by raising the real tax burden imposed on domestic corporations to offset the revenue loss from rate reductions proposed for individual taxpayers.

THE QUALIFIED RESERVE ACCOUNT

The QRA method of discounting loss reserves is the most harmful provision in the Administration's P&C tax package.

Under current tax treatment, P&C insurers can deduct, as present expenses, the funds they reserve for payments of losses in the future. P&C loss reserves are for insurable losses that have already occurred and they are totally expensed. Insurer acquisition costs are also expensed immediately.

QRA would change the current tax approach by requiring that only a discounted value of the reserve amount could be expensed. Discounting is based on the concept of a time lag (what the Administration refers to as "the time value of money") that exists between the occurrence of an insurable event and the date of payment. Under QRA, only an amount currently reserved which would grow by investment income to the amount needed in the future to fund the loss payment could be expensed for current tax purposes.

It is discounted by an investment income rate.

According to the company side of the P&C insurance industry, QRA poses a number of serious problems. It may impose a tax where there is no economic gain. It could push certain P&C companies experiencing temporary market difficulties into insolvency if the new tax burden caused them to lower reserves. It would reduce the reserve safety factor built into statutory accounting and be an incentive for companies to under-reserve. It may require state insurance regulators to require higher reserves to compensate for the capital reductions experienced by insurers hit with the increased federal taxes that QRA would impose.

Administratively, QRA would create substantial new bookkeeping burdens on P&C insurers. Joseph M. Jordan, a tax expert at Peat, Marwick & Mitchell, reports that a separate set of books would be required for each line of insurance that a company writes. Insurers may be required to keep three sets of books: a statutory accounting set for state insurance regulators, a general accounting standards set for stock companies reporting to the Securities and Exchange Commission, and a set(s) for the Internal Revenue Service for federal tax purposes. PIA would like to suggest that all of the additional accounting and bookkeeping needed to comply with QRA somehow does not seem to logically fit into a tax reform scheme that is being sold to the public as one of simplification and fairness.

QRA would have a significant impact on the cost of insurance premiums. A recent analysis by the A.M. Best Company, a recognized insurance research organization, indicates that QRA would cause premiums for P&C coverages to increase by an average of 11%. Certain lines of insurance would be much higher: 32% for medical malpractice, 15% for workers' compensation, and 24% for general liability. These QRA induced increases would be added on top of major premium increases already taking place in a hardening insurance marketplace. The costs of QRA will become an added cost of doing business and will inevitably be passed on to the insurance consumer as higher premiums. PIA believes that this price inflation would not be beneficial to the insurance consumer.

QRA is opposed by the entire P&C insurance industry. Companies and producers, representing both the stock and mutual sides of the business are united in their opposition to this ill-advised proposal. The trade associations representing the P&C insurers that will appear before the Committee today have analyzed the serious shortcomings of the QRA proposal in detail. PIA strongly urges the Committee to carefully consider the objections that they have raised.

PIA believes the QRA is a very bad idea that is being proposed at the worst possible time in the current underwriting cycle. P&C companies are now in the process of recovering from large underwriting losses experienced in recent years. This soft market situation is beginning to turn around and harden. At this stage of the underwriting cycle, a major new tax increase would be a significant and unwarranted new burden on the industry's financial position and impair its financial stability.

It is indeed unfortunate that the Administration appears to be unmoved by the petitions and analysis of the insurance industry regarding QRA and continues to press for the taxation of investment income generated by loss reserves. PIA trusts that the Finance Committee will consider this issue with a more open and objective frame of mind.

MUTUAL INSURANCE PROVISIONS

Mutual P&C insurance companies are owned by the policyholders they insure. Under current law, mutual P&C insurers benefit from certain tax provisions that recognize the special nature of the mutual organization. The Administration wants to change this situation in a manner that would have a serious impact on mutual P&C insurers. They propose a repeal of the PAL account provision which applies only to mutual P&C companies. PAL allows mutual insurers to defer a portion of their taxable income for up to five years as a cushion against future years when major or extraordinary losses may be incurred. PAL provides capital for mutual company underwriting needs throughout the underwriting cycle. It provides them with the ability to increase their capital to meet unexpected losses. Unlike stock insurance companies, mutuals do not have access to capital markets to raise funds. As a practical matter, mutuals can generate capital only through retained earnings.

Without PAL, a mutual can raise capital only by selling additional policies or inducing existing policyholders to contribute needed capital. Under current market conditions, neither of these approaches are practical in terms of covering a major loss situation.

PAL is therefore essential to the economic wellbeing of mutual P&C insurers throughout the underwriting cycle and has been part of the Internal Revenue Code since 1962. Mutual companies continue to have special need in raising capital to handle extraordinary losses. There is nothing to suggest that those needs have changed. PIA believes that the current PAL provision should be retained.

The Administration would also repeal certain tax advantages designed to help small mutual insurers. A recent survey conducted by the National Association of Mutual Insurance Companies shows that the repeal of these small company provisions would amount to a tax increase of 140%. This, when added to the increased tax burden of QRA, may well force a number of small mutual P&C insurers out of business. PIA urges the Committee to retain these small mutual company tax benefits.

Last, but not least, the Administration's tax package proposes to limit the deductions of mutual insurers for policyholder dividends. Under current tax treatment, such "dividends" are a proper deduction because they are, in fact, a return to the policyholder of excess premiums that are not needed to finance the insurer's insurance fuctions. The Administration's approach would amount to a new tax on equity because policyholder dividends flow to the mutual policyholder both as an owner of the company and as a policyholder. PIA believes that the deductions in current law for policyholder dividends provide a consumer benefit and should be retained.

When the Administration's tax proposals pertaining to mutual companies are added on top of a mutual's QRA tax burden, it amounts to a heavy new tax increase on the mutual side of the P&C industry. Now this approach may purport to broaden the tax base, but will it really? If a number of mutuals are forced out of the business by this tax package, that would certainly not expand anybody's tax base. Mutuals may not be able to pass these tax increases along to their policyholders as premium increases. The insurance consumers tolerance of price increases in many lines of coverage does indeed have certain limits.

The Administration's new tax plan for the P&C industry does not serve the public interest. It proposes a basic fundamental change in the longstanding public policy of supporting insurance in the Internal Revenue Code as a means of providing needed protection to the public. The essential public protections provided by the insurance industry would be reduced to achieve revenue enhancement should the provision discussed in this statement become law. PIA urges the Committee to prevent this from happening.

This tax plan could not be proposed at a worse possible time in terms of its potential adverse impact on the property and casualty industry. 1984 was one of the most difficult years that the industry has ever experienced. The underwriting cycle and soft market had bottomed out. Many insurers had their worst business year ever and many are still having financial difficulties. State insurance regulators are expressing serious concerns about their solvency. Early this year, the business started to slowly recover as the soft market reached its ebb and insurers began increasing premiums on almost all lines of insurance. The return to underwriting profitability appears to be getting underway but this is always a rocky road and there is still a long way to go.

Now comes the Administration seeking to impose major new tax increases on top of the already difficult financial condition P&C insurers are still experiencing. If these tax changes become law, this situation will only be exacerbated. Premium rates would have to be increased to finance the new tax burden over and above the major rate increases that are already taking place as the market and underwriting cycle continues to harden.

The QRA method of discounting loss reserves would cause large price increases in long-tail liability lines of insurance such as medical malpractice, workers' compensation, latent occupational diseases, traumatic injuries, and environmental pollution. This is a segment of our market that is already in serious trouble in terms of price, capacity and availability. QRA would only make things much worse.

Pricing problems will not be the only result of the P&C tax package should it become law. A serious capacity problem would also occur. Capacity is the total amount of a line(s) of insurance that a company can safely underwrite. Capacity is based on an insurer's reserves. With QRA changing the way reserves are calculated, the industry believes that capacity will decline with resulting reductions in capital. Prudent insurers seeing their capital decline will reduce the writing of certain lines of insurance. If a company cannot reserve at a level they are comfortable with, a decision may be made to withdraw completely from selected lines. The lines that will be the first to go in a tax induced capacity crunch should be the long-tail lines previously discussed. Certain high risk long-tail coverages may become unavailable at any price. These are lines that insure against risks for which the public, and in some instances the law, expects coverage to be available. It is important to stress that it is QRA that will reduce insurer capacity and this would occur no matter what conditions happened to exist in the insurance marketplace.

The serious problem that the Administration's tax package would impose on the domestic insurance industry and the political process thereinvolved are being carefully monitored by foreign insurers that are always exploring new opportunities to write business in the United States. The tax plan's resulting substantial cost increases and availability problems will put domestic insurers in a precarious competitive position, by giving their offshore competition a major price advantage because offshore insurers can circumvent both federal taxes, and state regulatory and statutory accounting requirements. The business placed with foreign insurers will be harmful to the stability of the domestic insurance industry and further aggrevate our balance of payments deficit.

Independent insurance agents are compensated by receiving a percentage of the premium dollar they produce. Anything that causes reduced insurer capacity and an availability problem for certain lines of coverage, directly and adversely impacts upon our ability to serve our clients and earn a living. The reduced insurance capacity that should result from the Administration's tax package will mean that less insurance coverage will be available for the consuming public and the agent's book of business will decline. As you can see, PIA's membership has very valid reasons for opposing the proposed P&C tax plan.

It is important to note that independent agents are already listening to vocal complaints from their clients who object to rising premium rates and protest availability problems caused by the hardening insurance market. PIA can assure you that if the proposed new P&C tax burden causes additional significant premium increases and capacity problems, those complaints will become howls of outrage. We must never forget that these citizens will also want to know what is responsible for the price and availability problems that they are experiencing and their agents have an obligation to inform them.

PIA urges the Members of the Finance Committee to look very carefully at all of the tax changes the Administration is advocating. We strongly urge you to preserve the provisions in the current tax code that are beneficial to the insurance industry and that support its fiduciary responsibility to provide essential economic security and socially accepted benefits to the public.

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Statement by

David L. Ream, CIC,CPIA
Chairman
Government Affairs Committee

of the National Association of

PROFESSIONAL INSURANCE AGENTS

concerning

THE IMPACT OF TAX REFORM
ON EMPLOYEE BENEFIT PROGRAMS

Submitted to the

COMMITTEE ON FINANCE

U.S. SENATE

July 19, 1985

The following statement is submitted by the National Association of Professional Insurance Agents (PIA) for inclusion in the hearing record of the Committee on Finance for the July 19, 1985 hearing on the impact of the President's tax reform proposal on employee benefits.

PIA is a national trade association representing 40,000 independent property and casualty insurance agents in all 50 States, the District of Columbia, Puerto Rico and the U.S. Virgin Islands.

The typical PIA member is a small businessperson with three or four employees. They typically represent seven insurance companies which enables them to provide maximum insurance services and protection tailored to meet their clients' needs. The PIA member is often a community-minded leader active in local service and volunteer organizations.

On May 28, 1985, President Reagan released his Administration's plan for a comprehensive revision and "reform" of the Internal Revenue Code of 1954, as amended. This plan proposes a number of very controversial changes in the current tax treatment of employee benefits. If these changes were to become law, employees would be required to pay income taxes on all or a part of their employer's cost of providing various employee benefits. Such benefits are generally tax preferred or tax exempt under current law.

The plan has generated considerable grass roots activity from a multitude of interests that would be adversely affected. A broad based coalition of insurance, business, labor, and service organizations, formed to oppose the original Treasury Department employee benefits taxation recommendations, is actively opposing the President's employee benefits tax proposals. PIA is a member of that coalition.

Congress has long supported, as a matter of public policy, the use of tax incentives to encourage the development and implementation of private employer-provided benefit programs to ensure economic security and adequate health care for employees and their dependents. Group life insurance and pensions have received preferred tax treatment since the inception of the federal income tax, and for the last three decades group health insurance has been tax-free. Pension plans have also been encouraged by more recent legislative activity

The cumulative results of this effort by Congress to promote private sector employee benefits has become one of our nation's great legislative and social policy success stories. The current use of tax incentives to support employee benefits such as pensions, health insurance, life insurance, dental insurance, and disability coverage has resulted in a cost effective delivery system that provides essential financial security for millions of employees and their dependents. Eighty-two percent of workers are now covered by pensions for retirement and related savings plans. Neary 80 percent receive group health insurance coverage. Americans have come to expect and believe that adequate tax preferred employee benefits will be provided by their employers. These benefits are simply taken for granted as a requisite condition of employment.

By encouraging the growth of private sector benefit plans, the government also supplements and strengthens the effectiveness of existing federal benefit programs such as Social Security, Medicare and workers' compensation.

Current law exempts from taxation as employee income employer-provided health insurance, group life insurance, death benefits, group legal insurance, dependent care, scholarships and fellowships, and awards for exceptional performance.

The Reagan Administration proposes to curtail or eliminate the tax preferences for a number of important employee benefits. This appears to be an integral part of their tax reform package which, if it is to be successful, must expand the taxable revenue base so that tax rates for individuals can be reduced while maintaining revenue neutrality. Viewed from this perspective, the tax reformers at the Treasury Department see the dollars spent on employee benefits as a potential revenue plum, ripe for the picking.

Although employee benefits, on average, constitute one-third of total employee compensation, most are either taxable as ordinary income at some point or are required by government. In reality, only around 4.5 percent of total employee benefits are tax exempt. PIA would, therefore, like to suggest that the loss to the Treasury caused by tax-free employee benefits may not, in reality, be as much of a problem as the Administration contends.

The National Association of Professional Insurance Agents strongly opposes any taxation of employer-provided employee benefits. The preservation of the present tax treatment of employee benefits is essential for assuring the continuation and expansion of the benefits currently provided to workers and their dependents. These benefits are necessary for the health, economic security, and well-being of the American people.

Last year, the Treasury Department's tax reform recommendations (Treasury I) proposed a so-called "cap" on the tax exempt treatment of employee group health insurance. Employer premium payments in excess of $70 per month for individuals and $175 per month for family coverage would become taxable income to the employee.

The cap approach would cause serious consequences for certain groups of employees. Older workers generally have a greater need for health care services. This cap would tend to induce younger healthy workers to either drop health coverage or limit it to the amount that could be obtained within the cap to avoid a tax increase. Older workers, the additional taxes notwithstanding, would continue to demand full coverage for obvious reasons. This result would be a classic case of what the insurance industry calls "adverse selection." The aggregate group premium base would be reduced by the response of younger workers, leaving older employees and their employers to face much higher health coverage costs. Workers engaged in hazardous occupations would also be placed in an adverse selection situation by the cap.

In certain areas of the country, such as New York and California, health care costs are much higher than the national average. Employees in such high cost areas must, as a practical matter, exceed the cap and incur a tax increase simply to obtain minimal adequate coverage.

There is reason to believe, based on Treasury Department statistics, that the cap would impose an income tax increase on about 50% of employees receiving employee health care benefits. This additional tax burden would be concentrated among those categories of workers most in need of health care coverage and fall heavily on those in lower income occupations. The average age of PIA members is 47 and the cap would, therefore, burden them with the problems that it would cause for all older employees.

PIA is totally opposed to the Treasury I cap concept.

The vigorous political protest generated by the cap may have persuaded the Administration to offer an alternative method of taxing health care benefits because their May 28th tax package proposed a so-called "floor." The floor would tax, as employee ordinary income, the first $10 of monthly health care benefit costs for individuals and the first $25 for family coverage. It would have less adverse impact on those employees who are in poor health, older, engaged in hazardous occupations and reside in high health care cost areas, but it also creates other serious problems of its own.

A floor would impose an additional income tax burden on all working individuals and families that receive employer-provided health care benefits. Its harshest impact would fall on low income families that could least afford this new tax burden as a percentage of disposable income. It lacks any incentive for employers to efficiently provide and employees to efficiently utilize health care benefits options, a goal some contend a cap would encourage. The floor's only benefit to anyone would be to the tax collectors as a revenue raiser. It would be a regressive tax increase on millions of American workers.

PIA is totally opposed to the Administration's tax floor on employee health care benefits. We believe that there should be no taxes imposed because essential health benefits to the employed public would be compromised and this would constitute an unwise and harmful change in public policy. It is without merit.

Treasury I recommended the repeal of the popular Section 401(k) plans that allow employees to contribute either 25% of their income or $30,000 annually, whichever is less, to an employer-sponsored tax-free profit sharing/savings program to provide for their retirement.

The Administration's plan compromised on the Treasury's approach by limiting the Section 401(k) contribution to $8,000 minus Individual Retirement Account contributions. Employees would not be permitted to utilize their accumulated Section 401(k) contributions on a "hardship" basis to meet an emergency need for funds. A difficult to comply with "actual deferral percentage" test would replace the existing participation test.

The result of these proposed Section 401(k) amendments will be reduced participation because employees would lose the ability to make hardship withdrawals without incurring a penalty. Employers will face new administrative costs and difficult to comply with regulatory burdens that will make the offering or continuation of Section 401(k) plans a much less attractive proposition when compared to the current program.

PIA believes that the Administration's Section 401(k) amendments would be counter-productive and discourage employer/employee participation in this worthwhile retirement savings program. This is certainly not the way to induce people to provide for their retirement years. These amendment should not be considered or approved by the Committee.

Under the Administration's proposed treatment of retirement programs, other than Section 401(k) plans, early withdrawals would be subject to a new 20% federal excise tax. This is a rather stiff tax bite that is excessive. There is also a hardship provision that would reduce the 20% penalty to only 10% if the distribution is used for college expenses, the purchase of a residence or to cushion unemployment. Again, this heavy-handed approach would discourage many employees from participating in these retirement programs and would reduce a retirement plan's functional utility over the years. PIA beleives that this approach would be counterproductive and a step backward which the Committee should not take.

Current law excludes from income taxation $5,000 in employer-provided death benefits. The Administration would repeal this provision which is designed to help a worker's dependents provide for a proper funeral and meet related expenses. This proposed amendment lacks any redeeming merit.

The sweeping changes in the tax treatment of employee benefits recommended by the Administration ignore important social goals carefully charted by the Congress over the years. The only real purpose of said changes is to raise revenue, but they would also undermine an important aspect of the financial security provided by the private sector to millions of citizens.

PIA recognizes the need for tax reform and to reduce the federal budget deficit. However, it is important that Congress not lose sight of the tremendous positive impact that employee benefits have on our nation's social and economic well-being. Providing the tax incentives that make benefit plans attractive to employers and employees helps further the laudable public policy goal of increasing the private sector's self reliance and of decreasing dependence by our citizens on costly federal entitlement programs.

These proposed new taxes would threaten the security and well-being of employees and their dependents. If such taxes are enacted, employers and employees alike would immediately re-evaluate the status of their benefits package. Employers would reduce the spectrum of benefits available to workers to avoid added administrative expenses and tax withholding burdens. Employees are likely to decline or opt out of portions of the protections available to them to avoid paying the higher taxes that would be due if they were to participate. This would leave these hard working citizens and their families dangerously vulnerable to financial disaster should serious illness, injury or other calamity strike a household lacking adequate coverage.

The advent of tax preferred employee benefits has been a great assistance to smaller businesses such as the insurance agencies run by PIA members, because it allows them to match the benefits offered by larger employers in attracting and retaining quality employees. Taxing those benefits could jeopardize their ability to compete in this vital area.

Many independent insurance agents would face a double-barreled problem, if employee benefits were to be taxed, because they wear two hats. They are both an employer as owner of their agency, and an employee of the agency as chief executive officer. They would be hit with all of the costs and administrative disincentives that would be imposed on the corporate entity, and also have to face the added tax burden as employees. This situation would be a double incentive for them to reduce the scope of employee benefits currently offered by their insurance agency.

The proposed tax on private sector employee benefit plans would be a major step backward. Many employers and employees would be discouraged from participating in private plans and they would eventually turn for protection to the federal government which would be forced to step in and fill the void with costly new entitlement programs. Consequently, even more of our citizens would become reliant upon the federal government for basic security needs. This would impose additional future budgetary problems on the Congress and increase the real tax burden on the American people. Within this context, PIA doubts that anyone could seriously or honestly argue that the federal government could somehow provide these health and life insurance, and retirement benefits at a lower aggregate cost to society than the current tax preferred private sector employee benefit programs. If the experience with existing federal entitlements is any indication, such new federal welfare programs would cost the Treasury far more than is currently lost in revenue under the existing tax preferred employee benefits structure.

The present employee benefits situation works very well, is cost efficient, and benefits millions of Americans. PIA would like to strongly recommend to the Committee that, "if it ain't broke," which it isn't, "don't try to fix it." It should be Congress' goal to continue moving forward in this area, not backward. You are entrusted with preserving the progress that has been made in this area.

Public Securities Association
1110 Vermont Avenue, N. W.
Suite 1075
Washington, D.C. 20005

WHAT THE TAX REFORM BILL WILL MEAN TO THE ISSUANCE OF MUNICIPAL DEBT

Introduction

State and local governments' ability to meet their financing needs will be seriously handicapped if The Tax Reform Bill of 1985 (H.R.3838) is enacted in its current form. As illustrated below, the changes to Section 103 of the Internal Revenue Code hit state and localities hard on two fronts. Provisions of H.R. 3838 eliminate or severely restrict both projects financeable under current law and the financing techniques used to maximize cost savings for state and local issues. In many instances, the elimination of cost savings techniques prohibits otherwise viable projects.

In curtailing the power of state and local governments, H.R.3838 violates fundamental notions of federalism. The Bill completely disregards the doctrine of reciprocal immunity, forces complex and inherently costly record keeping requirements on issuers and conditions tax-exemption upon requirements which often are beyond the issuer's control and which many issuers may be precluded from complying with because of prohibitions in their state constitution.

H.R.3838 does additional damage to municipal issuers through its inconsistency with other major policy intiatives of this administration. The emphasis on privatization in mass transit, for example, does not blend well with a bill that responds to even minimum levels of private involvement in projects with volume limitations or outright prohibitions through taxation. The increasing shift from the federal to the state and local level of responsibility for provision of public services is inconsistent with the restraints on infrastructure financing contained in H.R. 3838. Such policy initiatives together with the effects of H.R. 3838 will, in tandem, bring severe pressure upon a state's financial capacity to provide public services.

H.R. 3838 will have far-reaching substantive effects on the issuance of all municipal debt for public purposes.

Specifically,

- The Bill attacks the principles of federalism by invading the constitutional standard of reciprocal tax-exemption between state and federal debt securities.

- The Bill is not merely an attempt to simply curb perceived "abuses" in tax-exempt financing. Most if not all abuses were eliminated by the tax legislation enacted in 1982 and 1984. Ironically, small issue industrial development bonds, long viewed as a source of problems, are given new life by the Bill.

- This Bill is a major new step in the two-decade long attempt to regulate or eliminate all tax-exempt bonds. The Bill is a radical extension to all municipal debt, including general obligation and traditional revenue bonds, of rules and restrictions originally designed for corporate-related industrial development bonds.

- The Bill seeks to establish the principle that the Federal Government, by itself, can define which of the bonds issued by state and local governments are for "essential" functions and which are "nonessential." These "nonessential" functions include: airports, hospitals, student loans, multifamily housing, sewage disposal facilities, solid waste disposal and resource recovery facilities, ports, mass commuting facilities and water supply systems.

- Based on these categories, the Bill makes "tax-exempt" interest on so-called "nonessential" purpose bonds subject to the tough new federal "alternative minimum tax," thus partially removing the exemption and significantly raising interest costs to the issuer.

- The Bill totally denies tax-exemption for other specific public benefit facilities. These include: pollution control facilities; convention centers or sports facilities where any limited group of organizations has an extended right to use the facilities; parking facilities except at airports; local furnishing of gas or electricity; and local district heating and cooling facilities.

- Even general obligation bonds and traditional revenue bonds can be "nonessential" purpose bonds, and be subject to the alternative minimum tax regardless of the credit or tax source supporting the financing if more than $1 million of the issue is "used" in private business, such as through a facility management contract or operating agreement.

- The broad definition of "use" would deal a death-blow to "privatization" efforts and most public-private cooperative ventures.

- The Bill severely limits the ability of all issuers to refinance debt so as to achieve interest rate savings, remove restrictive covenants, or restructure debt. See summary grid attached as Appendix A.

- The Bill sets forth a number of detailed, redundant, and, in many cases very harmful procedural rules, the violation of which can make any bond issue retroactively taxable to the date of issuance. The Bill eliminates protection to bondholders provided by the "reasonable expectations" test of current law and regulations. Instead, uncontrollable events delaying expenditure for bond proceeds, for example, would mean non-compliance "in fact," and retroactive taxability. This unprecedented risk means that buyers will demand higher yields for all municipal bonds issued after 1985. The added interest cost to state and local governments is not matched by any corresponding benefit to the Federal government.

- Already, the Bill, with its effective date of January 1, 1986 (and expected but unfortunate qualified legal opinions) has substantially raised the cost of borrowing for the few issuers that have come to market this year -- as much as one-half percentage point for established general municipal issuers.

- The Bill imposes new detailed arbitrage restrictions which requires all issuers to pay the Treasury what amounts to a 100% tax on net earnings on investments.

- The Bill prescribes "micro-management" of state and local fiscal affairs by mandating detailed expenditure, reporting, remittance and accounting requirements pertaining to bonds.

- No other section of the Tax Code has seen so many new substantive restrictions added by tax legislation in 1980, 1981, 1982 and 1984.

- This legislation is a clear attempt to establish the precedent that Federal rules should govern every aspect of the issuance of state and local securities.

H.R.3838 restricts or prohibits projects in virtually every category and affects every issuer as described in part A below. Provisions of the Bill are inconsistent with national policy goals and severely limit traditional benefits enjoyed by states and remove cost saving financing techniques as described in Part B.

PART A. EFFECT OF H.R. 3838 ON ISSUERS AND PROJECTS

ALL ISSUERS, INCLUDING GENERAL OBLIGATION ISSUERS

Many of the provisions of H.R. 3838 cut across all types of projects and issuers. The Bill would impose the following new restrictions and create the following conditions on all issuers:

- It would require careful accounting of the specific uses of the proceeds of the bond issue, project by project, use by use, for the life of the issue.
- It would make taxable any bond issue from which more than $1 million of bond proceeds are for facilities "used" by anyone other than state or local government (a newsstand concession at City Hall is a "use"), unless a volume cap allocation is obtained (see below).
- It would by and large prohibit any bond issue in which 5% or $5 million (whichever is less) is "loaned" to others except for specified uses.
- It would mandate, on pain of taxability, detailed reports to the U.S. Treasury.
- It would subject all bond issues to new expenditure rules (see below).
- It would subject all bond issues to tough new arbitrage and rebate provisions (see below).
- It would sharply limit issuers' ability to refinance debt (see below).
- It would, as of 1/1/88, subject to an alternative minimum tax all bonds purchased by property and casualty companies.

Volume Cap

- The Bill would impose a Statewide volume cap for all of the following:
  - All housing bonds.
  - All exempt small issues.
  - All bonds issued for private charitable hospitals and colleges (501(c)(3) entities).
  - All student loan bonds.
  - All redevelopment bonds.
  - All solid waste facility bonds "used" by nongovernmental parties.
  - All sewage facilities bonds "used" by nongovernmental parties.
  - All water supply bonds "used" by nongovernmental parties.
  - All mass commuting facilities "used" by nongovernmental parties.
  - The portion of any bond in excess of $1 million used by nongovernmental parties.
- The annual volume cap per State is the greater of $175 per capita or $200 million.
  - $25/capita or $30 million is reserved exclusively for charitable hospitals and colleges.
  - $75/capita or $85 million initially is reserved for housing.
  - $75/capita or $85 million initially is reserved for all other affected purposes.
  - Half of all allocations initially are reserved for distribution by the State, half for distribution by local issuers.
- The Bill establishes complex allocation and reallocation procedures among issuers.

Expenditure Rules

The Bill would:

- Mandate expenditure of 5% of bond proceeds within 30 days of issuance (regardless of Federal, state or local bidding law and contract procedures).
- Mandate expenditure of all proceeds and investment income within 3 years.

Arbitrage and Rebate

The Bill would:

- Add a new Federal law that bonds can become retroactively taxable to the date of issuance as a result of noncompliance with arbitrage and rebate rules.
    - Because of constitutional requirements that current legislatures authorize expenditures of moneys in their general fund, compliance with rebate requirements may be difficult for some states; opinions as to tax exemption based upon enforceability of compliance covenants will be difficult to come by with the result that the bondholder must live with uncertainty as to the tax exempt nature of the obligation.
- Add complicated and substantive procedural rules regarding investment of all bond-related funds, and would:
    - Rebate to the Treasury any net earnings on all invested funds.
    - Deny an issuer the ability to invest at a rate that reflects its true borrowing cost (overturning the judicial interpretation of Internal Revenue Code Regulations set forth in State of Washington).
    - Sharply limit, to as little as 30 days, the period of time in which construction funds can be invested at an unrestricted rate.
    - Mandate complex accounting, segregation and monitoring of bond-related funds.
    - Impose complex bidding and certification requirements for the purchase of investment contracts and CDs.
    - Effectively require that reserve fund investments be liquidated over time and invested in SLGS.
    - Broaden the category of restricted investments to include annuities and "investment-type property."

Advance Refundings

The Bill would:

- Generally prohibit advance refundings of municipal debt (including refundings for interest rate savings) except under specific and complex conditions.
- Generally prohibit advance refundings of nonprofit, charitable hospital debt, even where substantial interest cost savings could be realized.
- Effectively prohibit refundings to restructure debt and to eliminate troublesome covenants.
- Retroactively cause the loss of unrestricted investment of pre-1986 bond proceeds that are advanced refunded.
- Overturn State of Washington, which allowed issuers to invest at a rate reflecting their true borrowing costs.
- Subject the portion of otherwise exempt refinancing of bonds with more than $1 million nongovernmental "use" to the State volume cap.

The bill cuts across the board in reaching all issuers of tax exempt securities with its limitations. The additional costs inherent in the accounting and record-keeping necessitated by the bill, coupled with the loss of arbitrage earnings during construction, the restriction of advance refundings and the imposition of a confining volume cap drastically reduce the available financial tools states and localities may use to efficiently meet their needs.

PUBLIC POWER

Tax exempt financing of public power projects is hit from a variety of angles, with the result that projects become exceedingly difficult if not impossible to finance under the strictures of the Bill.

Overall Impact

- The Bill would substantially raise the cost of public power due to:
  - Higher interest rates.
  - Difficulty in attracting industrial customers due to "use" restrictions.
  - Increased reliance on wholesale power supply from investor-owned utilities.
  - Elimination of earnings on construction funds and reserve funds.
  - More frequent bond issues as a result of expenditure rules.
  - Greater difficulty in refunding debt for interest rate savings or to restructure legal covenants.
  - Increased administrative requirements with respect to bond issues.

Joint Ownership/Use

- The Bill would prohibit "use" by any of the following of more than 10% or $10 million (whichever is less) of the power facilities financed.
  - Industrial customers.
  - Federal facilities, including military bases.
  - Investor owned facilities.
  - Hospitals and universities.
  - Federal marketing agencies (Bonneville, SEPA, TVA, etc.).
  - REA cooperatives.
- "Use" of the financed facilities in excess of $ 1 million per bond issue would require a volume cap allocation from the State in order to retain tax-exemption.
- "Use" includes take and pay contracts, take or pay contracts, capacity contracts, and sellback contracts and (possibly) all requirements contracts.

- The Bill would prohibit "loans" of more than 5% or $5 million (whichever is less) to any of the above.
- "Loans" would include take or pay contracts, contracts for capacity, and sellback contracts.
- Any use or loan, no matter how small, counts.

Other Rules

- All bonds would be subject to the general new restrictions, expenditure rules, arbitrage and rebate rules, and advance refunding rules, described on pages 4 through 7.
- The expenditure rule in the Bill would effectively prohibit forward financing of large-scale projects with long lead times.

Power projects generally require assembly of enormous amounts of capital, which, in light of the expenditure, user and cap restrictions set out above, may prove impossible to attain.

OTHER PUBLIC FACILITY BONDS

Civic amenities that have come to be taken for granted by much of the population will no longer be financeable without adding a contribution to the federal treasury to the cost of borrowed funds. Many projects are precluded outright from obtaining tax-exempt financing, others severely restricted.

Prohibited Projects

- The following generally could no longer be financed:
  - Pollution control facilities.
  - Convention centers.
  - Sports facilities.
  - Parking facilities (other than at airports).
  - Airport hotels and restaurants.
  - Industrial parks.
  - Local furnishing of gas or electricity.
  - Local heating and cooling facilities.

Restricted Projects

- The following generally could be financed only subject to severe new limits:
  - Airport terminal and hangar facilities.
  - Dock and wharf cargo handling and passenger facilities.
  - Water facilities.
  - Sewage and solid waste disposal facilities.
- All such projects except sewage and solid waste disposal facilities would have to be owned by a state or local government.

Prohibited Parts of Project

- Multiple source financing would be required for virtually all projects, because:
  - Property functionally related and subordinate to the purpose of the facility (e.g., offices) could not be financed on a tax-exempt basis, and
  - All of the bond proceeds would have to be used for qualified capital costs (i.e., the 10% "insubstantial portion" allowance would be eliminated).

Refinancing

- Advance refundings of 3-year notes would be prohibited.
- Permitted current refundings would be reduced from 180 days to 30 days.

Small Issues

- The Bill would eliminate the sunset in 1989 for such bonds.

Other Rules

- All bonds would be subject to the general new restrictions and expenditure rules, described on pages 4 through 7.

As indicated, the restrictions on many local improvements often used to spur economic growth are numerous. State and local governments may find themselves unable to encourage the development of particular areas or to enhance public services by providing convention facilities, parking facilities, hotels and restaurants - items which often form the catalyst for revitalization and expansion of commerce. Sewage and solid waste disposal facilities will be limited as the problems such facilities treat become more pressing on localities.

HOUSING

Multifamily Housing

- Volume cap would cut available financing nationally by about 50%.
- The new rules would seriously affect the feasibility of projects and would require much greater equity contributions.
- Low income rental requirements would be increased, from 20% of the units rented to families with income of 80% of median, to:
  - 30% of the units, or
  - 20% of the units to families with 70% of median income.
- The project would now remain subject to the rental requirement for at least 15 years (up from 10).
- Income limits would have to be adjusted for family size.
- Previously qualified tenants could be disqualified if their income increased to 120% of median income.
  - Continuous income reporting from tenants would be required.
- Property functionally related to the housing could not be financed.
- All bond proceeds would have to be spent on qualified capital costs (i.e., no working capital).

Single Family Housing

- New income limits would substantially cut the pool of qualified, creditworthy borrowers.
  - 50% must have income of 90% or less of the median.
  - 50% must have income of 115% or less of the median.
  - In targeted areas, 67% would have to have income of 140% or less of median income.

- Reduction of purchase price limit from 110% to 90% of average area price (from 120% to 110% in targeted areas) would eliminate many available houses.
- New restrictions on targeted area purchases (at least 50% must be first-time homebuyers) would reduce the number of homes financed in these economically distressed areas. The increase in such requirement in nontargeted areas (from 90% to 100%) would have a similar effect on homes financed.
- Volume cap would eliminate nationally about 50% of the available financing for single family housing.

Other Rules

- All bonds would be subject to the general new restrictions, expenditure rules, and arbitrage and rebate rules, described on pages 4 through 7.

The cutback in availability of and new restrictions on tax-exempt financing for housing makes affordable housing even more inaccessible to those least able to afford it and dulls the effectiveness of new housing as a tool for revitalizing blighted neighborhoods.

TRANSPORTATION

Mass Transit

The Bill would:

- Severely hamstring, if not kill, cooperative and joint venture efforts with private parties to provide mass transit.
- Prohibit financing for mass commuting vehicles not owned and operated by municipalities, even if operated only with a subsidy.
- Prohibit financing parking facilities (other than at airports) not owned, operated and used by municipalities, even if they serve a public need (i.e., park and ride centers).
- Severely limit financing for any other mass commuting facility involving concessions, management contracts or operating agreements, no matter how the financing is paid for.

Docks and Wharves

- General port facilities, no matter how great the economic benefit to the public, could be forced to compete for the limited volume cap.

Other Rules

- All bonds would be subject to the general new restrictions, expenditure rules, arbitrage and rebate rules, and advance refunding rules described on pages 4 through 7.

HOSPITAL, HIGHER EDUCATION AND OTHER 501(C)(3) FINANCINGS

Volume Cap

- All such financing would generally be subject to the volume cap ($25 per capita).
- The effect nationally of the volume cap would be to reduce available financing capacity to ONE-SIXTH of 1985 volume and ONE-HALF of 1984 volume.

Gross Limit of Debt

- The Bill would limit tax-exempt debt to $150 million outstanding at any time for any 501(c)(3) institution (other than hospitals).

Prohibition of "Advance" Refundings

- The Bill would prohibit any refinancing of debt more than 30 days prior to redemption of prior debt.
- There would be a lone exception for the refunding of pre-1986 bonds (but not post-1985 bonds) when bond covenants are in "conflict" with Federal rules.

"Nonessential" Function Bond Designation

- All such bonds would be subject to the alternative minimum tax for all taxpayers.
- The average maturity of the bonds could not exceed 120% of the average life of property financed, with special rules for treatment of land.
- Only tangible personal property and real property could be financed.
- All property would have to be owned by the 501(c)(3) organization.
- Only property directly related to the exempt purpose of the organization could be financed.
- None of the property financed could be "used" by others (no flower shops, no space used by medical PCs).
- All bonds would have to obtain "public approval" by designated elected officials.

- A public hearing would have to be held for all bond issues.
- The acquisition of existing property could not be financed, unless more than 15% of bond proceeds would be spent for rehabilitation.
- No more than 25% of bond proceeds could be spent for land.

Other Rules

- All bonds would be subject to the general new restrictions, expenditure rules and arbitrage and rebate rules, described on pages 4 through 7.

PART B: BEYOND "REVENUE NEUTRALITY": RAISING THE COSTS OF STATE AND LOCAL BORROWERS WILL HURT THE NATION'S ECONOMY

I. THE GOALS OF TAX REFORM

INTRODUCTION

Advocates of "Tax Reform" have stated that their continuing interest in revising the tax code in the midst of a massive budgetary and deficit crisis is based on urgent national needs:

- The U.S. must act promptly to enhance international competitiveness and stimulate overall growth in the U.S. economy.
- We must specifically re-target the tax code to encourage greater rates of capital formation and investment.
- Lowering overall tax rates by broadening the tax base and eliminating "egregious tax loopholes" will make a major contribution to general economic activity.

Supporters also argue that tax reform must be conducted in such a manner that the "fairness" of the tax code is enhanced while maintaining "overall revenue neutrality". The sheer length of the House's tax reform bill and the depth of detail it contains have all but eliminated "simplicity" as either a criterion for or description of the bill.

HISTORY OF CONGRESSIONAL ACTION AFFECTING TAX-EXEMPT OBLIGATIONS

On twelve separate occasions since 1968, Congress has enacted laws to restrict and regulate the use of tax-exempt financing by State and local governments. Since 1980 alone, three major laws have been passed making sweeping changes in the use of tax-exempt proceeds and establishing elaborate technical rules which must be met to insure tax-exemption. These rules already have increased substantially both the monetary and social costs of issuing tax-exempt bonds. Now H.R. 3838 threatens to multiply many times the restrictions, complexities and costs associated with tax-exempt borrowings.

This pattern of constant change, coupled with the threat of further more onerous restrictions, has destabilized the tax exempt market, caused many borrowers to rush to market precipitously out of fear of the unknown, and created an artificial market glut. In this time of enormous fiscal turmoil for state and local governments caused by the federal debt and budget crisis, and by the workings of the Gramm-Rudman Act, it is particularly important to provide some stability in the tax-exempt arena. The wisest and most prudent course for Congress would be to let the market stabilize by not enacting new changes in tax-exemption and to analyze, over several years, the effects of the recent changes, as well as their interaction with the debt reduction process.

COMPETITIVENESS & ECONOMIC GROWTH

H.R. 3838 stifles rather than encourages replacement, let alone expansion of our nation's infrastructure, the glue for a productive economy. It is impossible to argue with the premise that a great deal can and must be done to improve the performance of the U.S. economy and the ability of certain sectors to compete in international markets. Yet it is remarkable that the inextricable connection between the health of the economy and the condition of the nation's infrastructure has not occurred to those who drafted H.R. 3838. Indeed, a well developed and continually maintained infrastructure is probably the single most important precondition for sustained economic growth. Without roads, bridges, airports, water and sewer systems, electrical power, schools, housing, hospitals, mass transit facilities, and the rest of the vital framework of facilities that support modern life, the economy in any community will falter, stagnate, and decline. Astonishingly, this legislation deliberately places formidable barriers in the path of state and local officials attempting to meet the enormous challenge to expand, rebuild, and maintain our infractructure. Moreover, it does so just as the federal government is slashing programs which have in the past provided critical funding support for local and state governments. The issue is not whether the tax-exemption of state and local bonds is the most efficient way to provide federal aid to states and localities. In today's stark world of massive deficits, budget cuts, program eliminations, and Gramm-Rudman, it may well be the only way.

In addition, the tax exempt bond provisions in H.R. 3838 will dramatically increase the cost of the infrastructure that is built, by sharply limiting the amount of tax-exempt bonds which can be issued, and by introducing uncertainties which expose

bonds to retroactive taxation. These uncertainties will inevitably result in higher interest rates and costs incurred for continued monitoring of compliance with the complicated new rules of H.R. 3838.
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CAPITAL FORMATION AND INVESTMENT

Certain segments of the economy clearly require special tax treatment to encourage higher levels of+ investment. H.R. 3838 appropriately gives a great deal of attention to policies which will encourage capital formation and investment in specific sectors. Ironically, the bill also contains provisions which make it substantially less attractive for individuals and institutions to invest in state and local infrastructure through the purchase of tax exempt bonds. By making some municipal bonds subject to the alternative minimum tax and imposing the potential threat of having other bonds become retroactively taxable, the bill has shaken the concept of certainty of tax exemption and is already causing individuals and the vast majority of major institutions to sharply limit their municipal investments.

In contrast to some other segments of the economy, the market for tax exempt state and local bonds has worked well for many decades. Any notion that the tax exempt privilege is a "subsidy" provided by the Federal Government must be analyzed critically in light of the tax deductions afforded to all private sector borrowings and the subsidies granted to Federal borrowings by exemption of interest from all State and local taxes. While concerns about volume increases in the tax-exempt bond market are well taken, these increases for the most part are attributable to increased spending to fix unsafe, deteriorating and inadequate bridges and roads as well as sharply diminishing Federal funding for programs like low-income housing, transportation and wastewater treatment facilities. Further, it stands to reason that forcing some $100 billion of formerly tax-exempt borrowings to access the same pool of investment funds presently drawn on by the Treasury will inevitably result in higher financing costs for the Federal Government as well.

LOWERING OVERALL TAX RATES BY BROADENING THE TAX BASE AND ELIMINATING LOOPHOLES

Under extreme pressure to find deductions which could be eliminated to pay for lower rates, members of Congress have made the serious mistake of categorizing the exemption of state and local bonds as "just another loophole". It must be stated, in the strongest possible terms, that this exemption is firmly rooted in our Constitutional history. Reciprocal immunity from taxation has been a central feature of the Federal system since its inception. To consider the important principle of tax exemption of state and local bonds to be of the same character as the deductibility of business entertainment expenses or vacation home interest costs demonstrates just how far the principles of Federalism have been trivialized by Congress. It also calls into question the procedures of Congress in acting on such fundamental and far-reaching changes in tax exempt bonds without hearings, consultations or discussions, and without apparent recognition of the enormous negative consequences which could have been predicted and which have inevitably followed.

FAIRNESS AND REVENUE NEUTRALITY

It is irresponsible to confine the notion of revenue neutrality only to impacts on Federal revenue. H.R. 3838 fails to consider secondary economic effects on the cost of financing necessary infrastructure at the state and local level. Since all federal taxpayers are also state and local taxpayers, it makes no sense to save less than $1 billion annually at the Federal level at a cost of several times that amount to state and local governments.

II. THE ADVERSE EFFECTS OF DESTABILIZING TAX-EXEMPT FINANCING

THE IMPORTANCE OF CERTAINTY IN TAX-EXEMPT FINANCING

People invest in tax-exempt bonds precisely because they are assured that interest earned on such bonds will not be subject to federal income taxes. Based on that assurance, such investors accept less interest than otherwise. If interest on apparently tax-exempt bonds can become taxable without notice, the holder would be subject to taxes without earning a market taxable interest rate. Because taxability would be retroactive to the date of issuance of the bonds, the holder would also be subject to penalties. H.R. 3838 would radically increase the risk that tax-exempt bonds would become retroactively taxable. Accordingly, if H.R. 3838 is enacted in its current form, investors in all tax-exempt bonds will require additional interest to compensate them for this new risk.

When the first restrictions on the use of tax-exempt bonds were enacted by Congress in 1968 and 1969 (relating to industrial development bonds and arbitrage), Congress was careful to structure these restrictions in a manner that permitted the tax-exempt status of the bonds to be definitely determined on the date of their issuance. Not until the Mortgage Subsidy Bond Tax Act of 1980 did Congress depart from this policy, and even then excused noncompliance if good faith efforts at compliance were made and noncompliance was inadvertent or cured within a reasonable period. At about the same time the U.S. Department of the Treasury in several rulings make it clear that intentional acts, not foreseeable at the time of bond issuance, could cause bonds to become taxable. The Tax Reform Act of 1984 further departed from the principal of certainty at bond issuance but only with respect to the crucial matters of arbitrage within control of the issuer or other user of bond proceeds.

H.R. 3838 would significantly expand the circumstances under which acts or omissions subsequent to bond issuance can cause interest on the bonds to be subject to taxation retroactively. Some examples: Change in use of bond financed property neither foreseeable at time of issuance or necessarily within the control of the issuer or other user of proceeds; failure to file various periodic reports or certifications; failure to spend 5% of the net bond proceeds within 30 days and 100% within three years. Regardless of intention, effort or cause, any such act would cause retroactive taxability.

The penalty of retroactive taxability, with its concomitant risks and uncertainties, is simply not necessary to serve the goal of compliance with the tax code provisions. Ironically, increasing the uncertainty of tax-exempt status will only reduce the efficiency of what some characterize as a subsidy for state and local borrowers.

It is more rational and appropriate to permit the tax exemption of bonds to be concusively established at bond issuance. This could be done by covenants and conditions in the bond documents designed to legally require the issuer or other bond user to take all steps within their power to assure that the tax code requirements for tax exemption will be satisfied, and allow for noncompliance based on good faith mistake, inadvertence, or unforeseeable changes circumstance beyond the control of such issuer or bond user. The penalty of retroactive taxability contained in H.R. 3838 is not an effective deterrent, for the very uncertainty surrounding the ability to comply with such provision in an unpredictable future penalizes all, regardless of good faith or bad, with a market premium founded on a worst-case conclusion that bonds might become taxable. It is not good public policy to penalize the unavoidable or good faith instances of noncompliance when the penalty will fall on faultless bondholders. All state and local government borrowers will incur needlessly higher borrowing costs. State and local tax bills will rise without any net benefit to the U.S. Treasury.

GRANDFATHERING

Carving out a specific exemption from the onerous tax-exempt bond provisions in H.R. 3838 for a specific project on the drawing boards in a Senator's state may appear to be an easy way out of a tough legislative quandary. However, several projects supposedly grandfathered in the House bill were exempted only from the absolute prohibition of tax-exempt financing for sports facilities and the like. These "grandfathered" projects are treated under the bill as "non-essential function bonds" subject to state-wide caps, early issuance rules, alternative minimum tax and other restrictions of H.R. 3838. In other words, grandfathering is by no means an assurance that tax-exempt financing for a particular project will be available. A locality will still have to decide whether the grandfathered project or a solid waste plant is to be financed within the local per capita limit available. And, even if that determination is favorable, the impact of the alternative minimum tax on interest rates may render the grandfathered project unfeasible.

Grandfathering moreover is a tremendously misleading solution to the problems created for state and local governments by H.R. 3838. Grandfathering particular projects soothes only the immediate pain by preserving projects underway. It does not deal at all with the permanent disability inflicted on states and localities' capacity to finance their needs.

MINIMUM TAX

H.B. 3838 would add interest on "nonessential function" bonds as an item of tax preference for purposes of computing the alternative minimum tax for both individuals and corporations. This provision is highly counterproductive. Well-advised taxpayers would manage their alternative minimum tax liability to avoid paying it, in this case by not buying "nonessential function" bonds. Elimination of the demand represented by this substantial segment of the bond market will simply drive up the cost of all "nonessential function" bonds, requiring higher tax-exempt interest payments to taxpayers who do not face an alternative minimum tax situation. The result is, at best, higher costs for projects like solid waste disposal and low-income housing, and quite possibly, the elimination of projects rendered infeasible by higher financing costs.

"NON-ESSENTIAL FUNCTIONS"

H.R. 3838 defines as "non-essential" any financing which incidentally benefits anyone not a state or local government.

Assume that a particular state wishes to finance the clean-up of toxic waste sites without resorting to the Federal Super Fund Program. Virtually all waste dumps are situated on private property, and any clean-up program would enhance the value of the property or, at the minimum, relieve its owners from potential damage claims. Despite the obvious public benefits to be derived from such a program, H.R. 3838 would deny the tax-exempt privilege. By contrast, under current law, toxic waste clean-up could be done on a tax-exempt basis, because incidental "private benefits" of themselves do not result in loss of tax exemption. The "non-essential" definition is a counter-productive abandonment of the two-part test of current law, which restricts tax-exempt status where more than 25 percent of a bond issue's proceeds are used by nongovernmental entities and the repayment of the pro rata portion of debt service is secured by the promise of such entities to pay.

VOLUME CAPS

H.R. 3838 would permit tax-exempt bonds to be issued for the following purposes but only under a severe and complex rationing system based solely on the population of a state. The "ration card" for these projects imposes a total volume ceiling of $175.00 per person broken down into two volume caps of $150.00 and $25.00 for each state. (A different formula would apply to states with low populations.) These bonds are called "non-essential function" bonds in the House proposal.

The $150 Cap:

- Multi-family rental housing;
- Single-family housing for first-time home buyers;
- Mass commuting facilities;
- Sewage and solid waste disposal systems;
- Facilities for the furnishing of water, except for irrigation programs;
- Small issue industrial development bonds, including agriculture bonds;
- Student loan bonds;
- Veteran's mortgage bonds;
- Veteran's land bonds;

The $25 Cap;

A different rationing allotment of $25.00 per person would be subscribed for tax-exempt bonds issued to support non-profit hospitals, private universities and colleges, and other non-profit organization. No state could use this allotment for any other purpose, but additional bonds for this purpose could be issued under the $150 cap.

These caps are extremely restrictive and would sharply limit or eliminate access to tax-exemption for a large number of critically needed public projects. This is particularly true in light of the wide range of project types that will compete for a limited portion of the volume allocation. In comparing volume caps to needs, it should be noted that thirty-one states and the District of Columbia issued more bonds in 1984 than would be permitted under the $25 per capita cap for 501(c)(3) organizations. Also in 1984, twenty-six states issued more bonds than would be permitted under the $150 per capita cap. According to various estimates, aggregate 1984 volume in the categories included in the caps exceeded volume cap allocations by at least $5 billion. In addition, approximately $12 billion of bonds were issued in categories that would lose tax-exempt status entirely under the Bill. Since the volume limitations are so restrictive, large numbers of critically needed projects would clearly not be funded with tax-exempt bonds.

The wide variety of project types that will fall under each state's volume cap will cause various political constituencies to compete against each other for a portion of the limited volume allotment. In many cases, needed projects may not necessarily have the political clout to receive favorable consideration. Carry-forwards for financings that take several years to plan and finance will also be difficult to justify, in spite of a given project's merit. Quite simply, there will be pressure to spread available allocations among a wide range of relatively smaller projects.

Even governmental projects which include one or more concessions or other facilities or uses that are deemed nongovernmental, (including long-term service contracts and facilities for 501(c)(3) organizations), which exceed $1 million in aggregate size, would trigger the need for the issuer to get an allocation under a state's volume cap. A large number of general obligation issues (including, for example, highway bonds) now include portions that fund such facilities. This provision would force even general obligation issuers to go "hat in hand" to their state allocation agent to receive volume cap allocations. Of course, if the nongovernmental portion of facilities exceeded the lesser of $10 million or 10% of bond proceeds, a project that otherwise meets the definition of a governmental facility would generally not be allowed to be financed with tax-exempt bonds at all.

By setting the volume caps at low levels, and by assuming that states have equal needs, H.R. 3838 creates a situation where some states will be able to fund a large portion or all of their high-priority needs with tax-exempt bonds while other states will find that a large number of worthy projects remain unfinanceable.

Finally, relatively large projects, while theoretically permitted under the volume caps, will be virtually impossible to finance. In particular, mass commuting facilities, resource recovery plants and some large health-care projects would take a large share or even the entire amount of the volume cap in many states, and could probably not obtain an allocation. For example, the Mt. Sinai Hospital addition financed in 1985 would have used up the entire $25 per capita volume limitation for 501(c)(3) organizations in New York State.

ADVANCE REFUNDINGS OF TAX EXEMPT BONDS

H.R. 3838 requires the issuer, in a "low-to-high" advance refunding, to call in the refunded bonds at the first call date. This would effectively eliminate low-to-high refundings, since it makes them prohibitively expensive.

Background

Municipal revenue bonds are paid off with the revenues generated by the rates assessed (sewer, utility, hospital, etc.) to the rate payers. The bonds are issued with strict conditions on them (restrictive covenants) which must be complied with as long as the bonds are outstanding. The bondholders are entitled to keep their bonds, and the bonds cannot be called in (paid off), until the first call date. A typical 30-year bond is usually not callable for at least ten years after the date it was issued. Further, in order to call it in at the first call date, the issuer must pay a premium to the bondholder of 3% to compensate him for not being able to hold the bond until its final maturity date.

What does a municipality do when, due to changes in federal regulations or economic conditions, restrictive covenants inhibit the continued operation of public utilities or sewer systems for which outstanding bonds were issued? Specifically, what does a municipality do when clean water policy mandates construction of major new wastewater treatment facilities and the original bond covenants relating to the issuance of additional bonds do not permit such a large new project? The municipality refunds the outstanding bonds in advance of their maturity in order to eliminate the restrictive covenants.

Mechanics of an Advance Refunding

What exactly is an advance refunding? Basically, the municipality issues a second set of bonds and uses the proceeds to pay off the original bond issue, in advance of its maturity date. There are two basic types of advance refundings - a "high-to-low" refunding done to take advantage of lower interest rates; and a "low-to-high" refunding, done to eliminate the restrictive covenants contained in the original bond issue documents or to restructure debt to avoid default. Once the second set of bonds is issued and sufficient money is available to pay off the first set, the restrictive covenants are effectively eliminated (defeased).

In a high-to-low refunding, done to take advantage of interest rate savings, the issuer pays off the original high interest rate bonds as soon as possible. But, if current interest rates are now higher than the rate being paid on the original bond (low-to-high refundings), the issuer would lose money by calling in and paying off the original low interest bonds. The issuer instead invests the bonds proceeds from the second issue in an escrow account and uses the escrow principal and interest to gradually pay off the interest and principal on the original bonds as they become due. The project's revenue stream (i.e., the rates or fees generated by the facility built with the original bonds), which was initially pledged to pay off the first issue, instead becomes available to pay off the second bonds.

The Treasury has established limits on the amount of interest that can be earned on the escrow account. The regulations on yield restrictions require that the escrow account's earnings be limited to the interest rate on the refunding bonds.

Thus, in a low-to-high refunding, the size of the second bond issue is generally limited by what the original revenue stream can support, given the interest rate on the second bond, and is calculated by figuring out how much money it would take, when invested according to the restrictions on escrow earnings, to pay off the interest and principal on the original bonds as they become due.

The municipality is also generally required by law to invest the escrow in AAA-rated securities, in order that the original bondholders, who will no longer be entitled to payment from the facility's revenues, will be adequately secured. The U.S. Government issues special below market rate securities, called State and Local Government Series ("SLGS") for this purpose.

These special securities are necessary because the yield on regular Treasury bonds (which are taxable) is usually greater than the yield that would be permitted on the escrow earnings. For example, even though regular U.S. Treasury bonds yield approximately 9%, since the tax exempt bond rate is approximately 8.35%, municipalities must invest their escrow so that they would earn no more than 8.35%. Thus, the Treasury issues these special securities, SLGS, at a "below market" rate, in order that the municipalities will have the securities that they are required to buy for their escrows.

*HF+

The Mandatory Call Requirement

The requirement that the original lower rate bonds be called well before their maturity forces the issuer+ to increase the size of the second (refunding) bond issue well beyond what the project's revenue stream provides to pay off the second bond issues.

This follows for three reasons:

1) The mandatory call requirement would vastly increase the amount of refunding bonds. Since whatever cannot be raised through escrow earnings must be made up by the size of the second (refunding) bond issue, the mandatory call provision requires a larger refunding issue than the size that would have been needed just to pay off the original lower rate bonds as they come due.

2) Since under H.R. 3838 the issuer can no longer invest the escrow at a rate reflecting its true borrowing costs, including costs of issuance (usually 2 to 3%), it must pay these costs out of cash on hand or further increase the size of its refunding bonds.

3) Additionally, the issuer must also pay an extra premium, equal to 3% of the amount of bonds being refunded, in order to compensate the bondholder for redeeming the bonds early.

Although H.R. 3838's mandatory call requirement increases the size of the second bond issue, it does nothing to increase the amount of the project's revenue stream now pledged to pay it off.

Since the original low interest rate bond issue was structured so that the project's revenue stream (hospital charges, sewer or utility rates, etc.) was sufficient to pay off the bonds at maturity, the existing revenue stream would hardly be sufficient to pay off a larger high rate issue. Consequently, a low-to-high advance refunding in compliance with the mandatory call provision could only be accomplished if the issuer enlarged the revenue stream by either assessing higher user fees or putting up the cash difference. Given the excessive amounts that would have to be raised in cash or fee hikes, the real effect of the mandatory call provision is to prohibit low-to-high advance refundings.

Without the ability to undertake "low-to-high" advance refundings, cities, states and other issuers will be severely limited in their ability to restructure their debt service and to be released from restrictions which are no longer desirable or in the best interest of their citizens. To prohibit such refinancings can only have a majority disruptive and costly effect on state and local issuers. In many cases, the proposal would significantly increase the cost of financing necessary facilities.

Unlike the debt of private corporations, which is for the most part unsecured, most municipal debt is backed by a pledge of specific revenues consisting of user fees or tax revenues. Before municipal bonds are issued, the municipality, whether it operates a water system, airport, or other revenue-generating public benefit enterprise, must agree by means of a contract commonly known as a bond resolution to raise a certain minimum amount of revenues. After deduction of operating expenses, the net revenues must be applied first to pay principal and interest on the municipal bonds.

These bonds resolutions, in most cases, were drafted in the 1960's and 1970's. In the case of a water or sewer system, ordinance provisions permitted the issuance of some additional bonds to accommodate normal, anticipated system expansion and replacement of capital assets, but not in amounts sufficient to meet evolving safe drinking or clean water standards. Similarly, airport revenue bond contracts drafted in the 1960's did not anticipate the structural changes brought on by airline deregulation.

In other cases, bond documents have been rendered obsolete by changes in the capital markets and the development of new cost-effective financial instruments. For example, most bond documents did not contemplate the issuance of low cost variable rate, short term notes.

"Low-to-high" advance refundings are the mechanism which permit municipal issuers to restructure their debt in line with current economic and financial market conditions. Certainly with respect to bonds issued prior to 1986, there is no good reason to enact tax legislation which effectively prohibits their use.

CONCLUSION

State and local tax-exempt borrowing is a time-honored financing tool that has long been a cornerstone of the nation's infrastructure. The provisions of H.R. 3838 would dramatically change the volume, purpose, cost, convenience, and stability of tax-exempt borrowing, with wide-ranging and severe repercussions for the ability of states and localities to finance the public services and facilities citizens expect from government. The tax bill's treatment of municipal obligations does little to further the stated objectives of its proponents, and much to disrupt state and local economies already besieged by cutbacks in federal assistance. These misconceived and counter-productive provisions of H.R. 3838 should not be enacted into law.

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THE REFUNDING GRID

		Refunded Bond Type	Permitted Refunding?	Increase in Principal Permitted?	Unlimited Extension of Maturity?	Volume Cap Required?	Public Approval Required?		Comments
Advance Refundings	Pre-1986	G.O., General Revenue	Y	Y	Y	Amt. more than $1M	N	N	
		Non IDB but more than $10M	Y	Y	Y	Amt. more than $1M	Y	N	
		Hospitals, Other 501(c)(3)	Y	Y	Y	Full Amt.	Y	Y	Covenants in conflict w/ Fed. Rules
		Housing	N	--	--	--	--	--	
		Others	N	--	--	--	--	--	
	Post-1985	G.O., General Revenue	Y	Y	Y	Amt. more than $1M	N	N	
		Non IDB but more than $10M	N	--	--	--	--	--	
		Hospitals, Other 501(c)(3)	N	--	--	--	--	--	
		Housing	N	--	--	--	--	--	
		Others	N	--	--	--	--	--	

Current Refundings		Refunded Bond Type	Permitted Refunding?	Increase in Principal Permitted?	Unlimited Extension of Maturity?	Volume Cap Required?	Public Approval Required?		Comments
	Pre-1986	G.O., General Revenue	Y	Y	Y	Amt. more than $1M	N	N	
		Non IDB but more than $10M	Y	N	N	Amt. more than $1M	Y	N	
		Hospitals, Other 501(c)(3)	Y	N	N	N	Y	N	
		Housing	Y	N	N	N	Y	N	
		Others	Y	N	N	N	N*	N	
	Post-1985	G.O., General Revenue	Y	Y	Y	Amt. more than $1M	N	N	
		Non IDB but more than $10M	N	--	--	--	--	--	
		Hospitals, Other 501(c)(3)	Y	N	N	N	N*	Y	Old bonds excepted from $150M limit
		Housing	Y	N	N	N	N*	Y	
		Others	Y	N	N	N	N*	Y	Under $10M - excepted from $40M limit if reduced rate

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*If no extension of final maturity

REPUBLIC NATIONAL BANK OF NEW YORK
FIFTH AVENUE AT 40th STREET • NEW YORK, N.Y. 10018 (212) 930-6000
TELEX 234967 CABLES BLICBANK NEW YORK

Statement For The Record
of
Republic National Bank of New York
Before the
Committee on Banking, Housing, and Urban Affairs
United States Senate
Hearings On
The Impact of H.R. 3838,
The House-Passed Tax Reform Bill,
On The International Competitiveness of
U.S. Banks And Other Businesses

February 10, 1986

SUMMARY

The current Subpart F exemption allowing deferral of U.S. tax on the banking income of U.S.-owned foreign banks should not be repealed, as H.R. 3838 would provide.

Under current law, U.S. tax is not levied on banking income earned by U.S.-owned foreign banks until the income is paid into the U.S. in the form of dividends.

H.R. 3838 would repeal current law by subjecting U.S.-owned foreign banks to current U.S. tax on their banking income.

* H.R. 3838 would severely jeopardize the competitive position of U.S.-owned foreign banks operating in lower tax countries and elsewhere. Thus, U.S.-owned banks will lose a significant portion of the international banking business to our competitors, primarily Japanese and Western European-owned banks.

* Repeal of deferral will reduce the rate of return and profits of U.S. banks with foreign operations, thus weakening the position of our banks among investors, creditors, and clientele.

* By damaging the competitive posture of our foreign banks, repeal of deferral would be detrimental to U.S.-based multinationals, which in many cases prefer to deal with U.S.-owned banks. In addition, repeal would cause U.S. banks to lose businesses that seek one international bank to provide a variety of services, including services in lower tax countries.

* Repeal of deferral will worsen the foreign trade deficit by reducing U.S. banking activities overseas.

* Contrary to the assumptions of the opponents of deferral, U.S.-owned banks establish operations in lower tax countries for valid business reasons, not tax avoidance. Many lower tax countries have become international banking centers because they allow banks to operate at reduced cost. U.S. banks establish operations there to participate in this market.

* Contrary to the views of opponents of deferral, repeal will not stimulate additional banking investment in the U.S. Due to the nature of banking, U.S. banks already seek to maximize their operations in the U.S. The establishment of foreign operations does not come at the expense of U.S. operations.

* Repeal of deferral will not raise significant revenue.

* Abuses that H.R. 3838 is directed against can be resolved by amending the Internal Revenue Code or applicable Treasury regulations so that only actual banks are eligible for deferral.

* The effective date of H.R. 3838's provisions repealing deferral should be postponed until January 1, 1987.

Republic National Bank of New York, headquartered in New York City, is the twentieth largest bank in the United States.

This statement focuses on the negative impact of one provision of H.R 3838 (the House tax reform bill) on the international competitive position of U.S.-owned banks: Repeal of deferral.

1. Current Law.

Under current tax law, income earned by U.S. owned foreign corporations engaged in an active banking business is subject to tax in the foreign country, and is not subject to U.S. tax. As a result, U.S. tax on this income is deferred until the foreign corporation pays dividends into the United States.

These provisions are part of long standing U.S. policy not to tax the earnings of active businesses operating abroad, until the income is paid into the U.S., in order to assure that our businesses can compete on an equal footing with foreign businesses.

2. H.R. 3838.

At the urging of congressional staff, and contrary to the Treasury proposals, the House Tax Reform Bill includes a provision to repeal deferral for certain types of active business income, including banking income. As a result, banking income earned abroad by a U.S.-owned foreign corporation would be subject to current U.S. tax.

The provisions of the House Tax Reform Bill are aimed primarily at bank earnings in countries with low nominal rates of tax. However, U.S.-owned banks operating in certain countries with high tax rates will also be adversely affected.

3. Anti-competitive Effects of Repeal of Deferral.

Repeal of deferral violates trade neutrality, and will significantly jeopardize the competitive position of U.S.-owned banks operating overseas, primarily those in lower tax countries. Lower tax countries have become international banking centers. These countries have attracted a major portion of the international banking market by relaxing regulatory requirements and currency restrictions, along with imposing low rates of tax. Because banks are able to operate at a low cost in these countries, they are able to provide favorable interest rates to depositors and borrowers. For this reason, international depositors and borrowers from around the world have been attracted to lower tax countries.

To take part in this major market, banks from many countries, primarily Japan, United Kingdom, Switzerland, West Germany, Canada, and France, along with the U.S., have set up operations in lower tax countries. In the 5 lower tax countries Republic operates in, subsidiary banks from the United Kingdom, Switzerland, and Japan have substantially more assets than U.S. bank subsidiaries. In all, U.S. bank subsidiaries own only about

11 percent of the banking assets in these countries compared with our principal competitors.

These intense international competitive pressures have greatly pushed down the margin of profit on loans made in these countries. In lower tax countries, there is a spread of approximately 40 basis points -- four tenths of 1 percent -- between the interest rates banks pay to depositors and the interest banks charge to lenders. As a result, a $1 million loan generally yields about $4,000 in gross revenues. After operating costs are subtracted, approximately $2,000 remains as profits. This amount of profit is adequate, although just barely so, because there is little or no tax imposed. Although profits on individual loans are very low, overall operations are profitable because of the huge loan volume. Because all banks provide essentially the same services -- buying and selling money -- both we and our competitors charge the same interest rates.

If the U.S. repeals deferral, our banks will have to pay taxes at the 36 percent U.S. rates. Our competitors, however, will continue to pay only the low taxes imposed in the lower tax countries. The home country of each of our principal competitors allows deferral of tax on the income earned by their foreign banking and other corporations. Indeed, several of our competitors' home countries provide tax treatment that is even more favorable by eliminating tax when income is repatriated into the home country.

As a result, if the U.S. repeals deferral, Republic and similarly situated U.S. banks will face an impossible dilemma that will cause us to lose a significant portion of the loan market in lower tax countries. Because of international competitive pressures, we will be priced out of the market if we attempt to adjust interest rates by even a few basis points, to cover the additional tax costs. On the other hand, if we absorb the additional tax costs, the loans will no longer be profitable because the lending risks will outweigh the reduced return. As a result, we will have no choice but to reduce our operations in lower tax countries. Our competitors, primarily Japanese- and Western European-owned banks, will gain the portion of the market that we lose.

Republic has already suffered from the possibility that deferral will be repealed. Since the House passed the Tax Reform Bill, we have reexamined our lending policy in lower tax countries. We are currently reducing the amount of long-term lending out of those countries because we are concerned that if deferral is repealed, we will be locked into long-term loans that are not profitable.

4. Other Negative Effects on Profitability Caused by Repeal of Deferral.

Repeal of deferral will have several other negative effects on the profitability of U.S. banks' overseas operations. Many countries, such as the United Kingdom, France, Italy, and Australia, have high nominal rates of tax, but allow reduced tax rates on certain types of banking income. If deferral is repealed, U.S.-owned banks will pay higher tax rates on earnings from these countries than our competitors will, which will reduce our ability to compete in these countries as well.

In addition, many of our customers are international businesses that look for the services of one international bank throughout the world. For example, some of our customers are commodities traders who trade around the clock, and thus need banking services in various time zones. If we are unable to maintain substantial operations in lower tax countries, some of these customers will transfer to our competitors all of their banking business, in lower tax countries, here in the U.S., and throughout the world.

Placing U.S.-owned banks at a competitive disadvantage is particularly inappropriate because foreign competitors appear to be competing more and more vigorously in our own U.S. banking market. Japanese-owned banks are among the most aggressive. Initially, they established operations in the U.S. primarily to service Japanese businesses operating here. Now, they are aggressively seeking to lend to, and issue letters of credit to, U.S. businesses, public utilities, and municipalities and their agencies. Our competitors' home countries do not enact tax laws that hamper their banks in competing for the U.S. banking market.

5. Adverse Effects of Reduced U.S. Bank Profits and Competitiveness.

The reduced ability of U.S.-owned foreign banks to compete will have many adverse affects. In general, the profitability of many U.S. banks which own overseas subsidiaries will be significantly diminished. Lower profits will weaken our position among investors, creditors, depositors, borrowers, and other customers. This weakening may set in motion a cycle that leads to further reductions in profits. On the other hand, our competitors, who will continue to receive high profits from their operations overseas, will find themselves in a relatively stronger position.

Our reduced operations in lower tax countries will have additional effects. Perhaps the most important is the trade deficit, expected to reach $150 billion in the near future. U.S. banks export financial services, and by doing so, earn profits abroad. Reducing the profits that we earn overseas can only worsen the trade deficit.

In addition, a number of U.S. multinationals prefer to do business with a U.S. bank. They have found that doing so allows them to become familiar with the operations of their bank, and to establish lines of credit throughout the world. If U.S. bank operations in lower tax countries are reduced, U.S. multinationals may be compelled to switch to our foreign competitors who can provide those services.

Most broadly, a sound U.S. banking system is vital for our economy and our government. The fact that the U.S. banking system has remained healthy is a principal reason why the U.S. continues to be the capital center of the world. Because capital continues to be attracted here, we are able to fund the budget deficit and maintain our economic expansion. The U.S. banking system is woven very closely together through the massive interbank lending market. The weakening of individual U.S. banks, as a result of repeal of deferral, will weaken the U.S. banking system as a whole.

6. Arguments Made by Opponents of Deferral.

The House Ways and Means Committee report, in defending repeal of deferral, argues strongly that the principal reason why U.S. banks go into lower tax countries is tax avoidance. This is not true. We establish operations in lower tax countries because they have become major centers of international banking. Businesses bank there in order to receive favorable interest rates. We establish operations in these countries because we seek to profit from the market opportunities.

Opponents also say that deferral encourages banks to establish operations overseas, at the expense of expanding operations in the United States. This argument is also falacious. Banks already have every incentive to expand U.S. operations as much as possible. We do so by finding more borrowers, and we can fund new loans simply by attracting new deposits. Establishing operations overseas means that we are able to penetrate foreign markets. This has little or no impact on our ability to exploit U.S. markets.

7. Revenue Loss.

There is very little revenue to be raised by repeal of deferral for banking. The entire package of almost a dozen changes to Subpart F included in the House bill will raise only $1.1 billion over five years. If deferral is repealed, we and other banks will be forced to reduce our operations in lower tax countries, which will virtually eliminate any revenue gain.

8. Alternative Proposal.

Some U.S.-owned foreign corporations do abuse the current banking exemption by engaging in a so-called banking business that is not in fact active banking. This abuse arises because the current I.R.S. regulations defining a banking business are vague and easily manipulated.

We recommend that the current I.R.S. regulations should be replaced by an objective test under which a business would be considered a banking business eligible for deferral only if it meets certain requirements. These requirements could include maintaining a specified relationship of deposits to capital and maintaining a specified relationship of loans to total assets. Strengthening the regulations in this manner will ensure that only actual, active banks qualify for deferral.

9. Effective Date.

The effective date of H.R. 3838's provisions repealing deferral should be postponed until January 1, 1987, pending congressional resolution of this issue. The uncertainty over whether deferral will be repealed will compel Republic to curtail its lending activity pending congressional resolution of the issue. A delay in the effective date would permit Republic to maintain a higher level of lending activity throughout 1986.

SAMA 1101 16TH STREET, N.W. WASHINGTON, D.C. 20036 (202) 223-1360

January 16, 1986

The Honorable Jake Garn
Chairman, Committee on Banking,
Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Garn:

Thank you for your letter of January 2, informing us of your plan to conduct oversight hearings on the international competitiveness implications of the House tax reform bill.

The companies we represent are major exporters, with 40% of their sales shipped internationally. But they pay one of the highest effective rates of U.S. tax on domestic income and, over the past few years, have lost world market share. Thus, from a global competitiveness standpoint our members are encouraged by the major thrust of this tax reform movement to lower corporate rates. However, they are concerned about certain specific provisions of the House bill that may hurt their ability to compete internationally.

1. Research and Development Incentives (Act Section 231)

The House tax reform bill extends the incremental research and development tax credit for an additional 3 years but does not make it permanent. It also reduces the rate of credit from 25% to 20%.

Comment: U.S. incentives for research and development are essential to maintain our nation's technological leadership and international competitiveness. American high technology companies are particularly constrained in the extent to which they can expand R&D by the high cost of capital relative to that of foreign competitors, and the extremely risky and long-range character of R&D. The R&D tax credit has permitted them to significantly increase R&D spending even during a recession. Our major business trading partners provide generous tax and financial incentives, on a permanent basis, for commercial research performed within their countries. A summary of those foreign incentives is attached. Without comparable U.S. tax breaks growing numbers of American firms will be at a competitive disadvantage in world markets and will be encouraged to conduct more of their R&D overseas. The R&D credit should be retained at its current rate and made a permanent part of our tax code.

SCIENTIFIC APPARATUS MAKERS ASSOCIATION

The moratorium prohibiting allocation of domestic R&D expenses against foreign-source income expired on December 31, 1985. Although former law had proved damaging to U.S. exports, the House bill provides a 2-year transition back to the old rules. This is not an acceptable solution from our perspective. It will discourage R&D activities in the U.S. and encourage the transfer of such activities offshore.

R&D must retain its favorable tax treatment in other ways. The current deductibility of research and development expenditures under Section 174 of the Code must be maintained, a proposition that was ultimately agreed to by the House. In addition, R&D expenditures should not be treated as a preference item for purposes of the corporate minimum tax. Otherwise, many companies in our industry will be forced to take more of their R&D work overseas because they must spend in excess of 100% of their net income on research each year to remain competitive. This, in turn, may lead to the export of U.S. manufacturing operations. Therefore, we believe it is critical that R&D expenditures remain currently deductible and not be treated as a preference item for minimum tax purposes. Again, the House concurred with this position.

2. International Tax Provisions (Act Section 601-616, 641 and 643)

The House bill reduces the value of virtually all international tax provisions including the foreign tax credit (Action Section 601-604), foreign-source income rules (Act Section 611-616), the possessions tax incentives under IRC Section 936 (Act Section 641), and the Foreign Sales Corporation provisions (Act Section 643).

Comment: The House bill creates technical and administrative problems in the foreign tax credit area which is already burdened with an extremely complex set of rules. They also discourage rather than encourage U.S. exports. These House changes will result in higher U.S. taxes and export prices at a time of record U.S. trade deficits. Therefore, we vigorously oppose most of the international provisions contained within the House bill.

3. Depreciation of Scientific Instrumentation (Act Section 201 and Committee Report No. 99-426, Page 153)

High technology scientific instrumentation now qualifies for five year depreciation unless used in research activities where it qualifies for three year depreciation treatment. Under the House bill, scientific instruments would be depreciated over a ten year period, or according to the classification of the customer's industry. The House Ways and Means Committee report directs the Treasury Department to study and make appropriate adjustments in the depreciable life for scientific instruments by 1987.

Comment: To help foster economic growth and global competitiveness, a capital cost recovery system should reflect the fact that rapid technological advances cause high technology equipment to have a very short economic life. The House bill is consistent with this philosophy as it applies to computers, semiconductor manufacturing equipment and certain other high technology electronic equipment. However, use of a short life for scientific instruments is deferred pending a Treasury study. We believe that the distinction between depreciation of instruments, especially computer-based products, and other high technology electronic goods should be eliminated. Otherwise, contrary to the stated goal of the new tax depreciation rules, the tax law may discourage business decisions to acquire up-to-date instruments which assist the research, production and quality control efforts of American companies.

SAMA is the national representative of the high technology instrumentation industry. Our 200 member companies, many of small or moderate size, manufacture and distribute more than 40,000 types of high technology instruments and related laboratory products. This equipment is used in research, production, quality control and regulatory compliance by government, industry, education, public utilities and health care professions. SAMA's members have combined annual sales in excess of $14 billion. Research spending by our industry has increased by more than 60% since 1980 and now represents about 6% of total sales. Member companies have facilities in virtually every state, and employ more than 250,000 workers.

Again, thank you for soliciting our views. We would be pleased to meet with you and your staff to discuss our comments in greater detail.

Very truly yours,

Michael J. Duff
Vice President
Public Affairs
SAMA

James A. Taylor
Assistant Treasurer
Varian Associates, Inc.
and Chairman of the
SAMA Tax Committee